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MONETARY POLICY AND THE STATE OF THE ECONOMY

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

JULY 20, 2005

Printed for the use of the Committee on Financial Services

Serial No. 109–47

U.S. GOVERNMENT PRINTING OFFICE

23–738 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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MONETARY POLICY AND THE STATE OF THE ECONOMY

Wednesday, July 20, 2005

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to call, at 10:04 a.m., in Room 2128, Rayburn House Office Building, Hon. Michael Oxley [chairman of the committee] presiding.

Present: Representatives Oxley, Leach, Pryce, Bachus, Castle, Royce, Lucas, Kelly, Paul, Gillmor, Shays, Miller of California, Kennedy, Hensarling, Garrett, Brown-Waite, Barrett, Gerlach, Pearce, Neugebauer, Fitzpatrick, McHenry, Frank, Waters, Maloney, Velazquez, Watt, Ackerman, Hooley, Carson, Sherman, Lee, Moore of Kansas, Crowley, Clay, Matheson, Miller of North Carolina, Scott, Davis of Alabama, Green, Cleaver, Bean, Wasserman Schultz, and Moore of Wisconsin.

The CHAIRMAN. [Presiding.] The committee will come to order.

The chair recognizes himself for an opening statement.

Chairman Greenspan, once again, we welcome you back to the Financial Services Committee for now your 35th appearance before this committee and our predecessor, the House Banking Committee, for the Monetary Policy Report.

I know I speak for all of our 70 members when I say that your economic analysis and our discussion with you is the highlight of our calendar year here at the Financial Services Committee.

Welcome once again, in what will likely be your final appearance here before the Financial Services Committee. To that end, we have enjoyed the opportunity to work with you in a number of capacities over the years, and I know I speak for the entire committee when I say that.

We can report to the nation today that our U.S. economic growth is steady and strong. While we face some uncertainty abroad, and we can be assured of the likelihood that there will always be uncertainty abroad, our national economic performance is the envy of the world. More Americans are working than ever before.

We recently received the news that 146,000 jobs were created in June, achieving a 5 percent unemployment rate, the lowest since the fateful month of September 2001.

Not so long ago, many economists believed that there was a structural unemployment floor of 6 percent or 7 percent. They did not believe that our economy had the ability to reach the goal of 5 percent unemployment, and yet it has done so this month, with a total of 1.1 million jobs created this year alone.

An important leading indicator, durable goods, increased 5.5 percent in May, and U.S. manufacturing continues to expand at rates that exceed expectations.

Our GDP is growing at a good clip of nearly 4 percent, and the important non-manufacturing sector has been increasing each month now for over 2 years.

The markets have risen nicely, recovering from their post-bubble and post-9/11 declines and selloffs, with the Dow now just 500 points shy of its historic high.

These positive economic conditions mean that more Americans than ever before have reached the goal of home ownership. With President Bush's housing policies and the American Dream Downpayment Act, home ownership will soon be within reach for even more American families.

With 14 consecutive quarters of economic growth, there is further good news for American consumers, and that is, inflation has remained in check. The prices of goods and services did not go up during the month of June. Prices for businesses, the producer price index, actually went down slightly, indicating that businesses have been able to handle recent high energy prices.

Americans are well aware of the economy's steady growth, low inflation, and strong housing markets. Consumer confidence numbers are optimistic, and economic predictions show annual growth in the 3 percent to 4 percent range.

A thriving economy, growing businesses, and working Americans are the components of a healthy tax base and strong revenues. President Bush's tax cuts have been an important factor in the recent projection that the federal budget deficit will be far lower than previously expected, perhaps up to $100 billion lower, and that will help to keep interest rates as low as possible.

Over the long term, the president's programs to make the tax cuts permanent, to restrain government spending, to ensure retirement security, and to expand U.S. exports through free trade will further enhance our economic success.

Mr. Chairman, according to the Federal Reserve Web site, its objectives include "economic growth in line with the economy's potential to expand, a high level of employment, stable prices, and moderate long-term interest rates."

It is an immense achievement that all of those objectives have been met, and we congratulate you and your colleagues at the Fed.

You have the distinction of having served the Council of Economic Advisers under President Ford and serving as the Fed chairman under every president since Reagan. Certainly the confidence of five presidents is also a testament to the nation's faith in your economic leadership.

We thank you for your extraordinary service to our country, for the stalwart policies that have guided us to many years of prosperity. This success has advanced American businesses, has increased American influence throughout the world, and has created economic conditions in which American families thrive.

I again thank you for your service.

I now yield to the gentleman from Massachusetts for an opening statement.

Mr. FRANK. Thank you, Mr. Chairman.

Mr. Chairman, I was reading your statement this morning and I had an "a ha!" moment and realized that I could from now on, to some extent, preach the gospel according to Greenspan, with some reservations—the revised standard version.

On Page 11, you state something really quite profound, that I hope people will take to heart. You and I will differ about how to respond to it, but I thank you for stating it. "We collectively confront many risks," then I skip. This is the chairman's testimony.

"Another prominent concern is the growing evidence of antiglobalization sentiment and protectionist initiatives, which, if implemented, would significantly threaten the flexibility and resilience of many economies.

"This situation is especially troubling for the United States, where openness and flexibility have allowed us to absorb a succession of hard shocks. That flexibility is, in large measure, a testament to the industry and resourcefulness of our workers and business. But our success has also been aided importantly by more than 2.5 decades of bipartisan effort aimed at reducing unnecessary regulation and promoting the openness of our market economy.

"Going forward, policymakers will need to be vigilant to preserve this flexibility, which has contributed so constructively to our economic performance."

I agree with you, Mr. Chairman.

I am going to solicit later your opinion of the bill dealing with trade with China, which is apparently going to be put forward as part of the price of winning CAFTA, and I will be interested in your evaluation of that particular piece of legislation—which has been the subject of a marvelous conversion on the part of many of the Republican leaders.

I agree with you that we face these attitudes, and I agree with you that they can have negative consequences. But I hope you will agree—and I think, from previous statements, you would—this is not simply perversity on the part of American citizens; this is not just the workers getting into a bad mood.

The problem is that the very growth that these policies have fostered, the growth that you believe to be endangered by the rise in these sentiments and the opposition to these measures, has increasingly been unfairly shared.

You said—and I salute you for it—a little over a year ago to the Joint Economic Committee that virtually all of the gains from increased productivity were going to corporate profits, the owners of capital; very few, if any, were going to real wages.

In the report this year, the Monetary Report, on Page 16, you do say, "Measures of labor compensation suggest that the remaining slack in labor markets continued to restrain increases in base wage rates."

You do note, "Large increases in some of the more flexible components have added to labor costs."

What are those? Stock options and bonuses, as you say.

In other words, if you are eligible for a stock option, you are doing okay. If you get a bonus, you are doing okay. If you are an owner of capital, you are doing super okay. And then, to make it even better, we have reduced the tax rates on all those.

But if you are working for straight wages or salary, you are not doing very well. Certainly you are not participating in the increased prosperity. Real wages, as you have acknowledged, leaving aside stock options, leaving aside bonuses—real wages—have not increased. Inflation has eaten them up.

It is true that some workers have been told by their employer, "We are giving you more in compensation." To some extent, that means the employer is paying more for their health care benefits, or perhaps putting more into the pension fund; but the worker is not taking home another penny.

And working people—and I want to go back. I think you are right about these sentiments, and I think you are right that they could lead to some negatives.

We have on a bipartisan basis in this committee—as you know, with the support and advice from your institution—allowed the financial institutions to take advantage of information technology. We have done things to try and help them modernize.

There is growing consumer resistance to many of those. There is resistance to trade, so that they are going to have to make this bargain, they are going to try and buy CAFTA with this China deal. I do not know if it will work or not.

The point I am making is this, you have got to connect the dots. The fact is that increasingly average workers do not see that the prosperity that results from these policies is benefiting them. And in fact fewer Americans are getting health benefits. They are paying more for them.

And so this combination of increased growth—and the economy is growing—and job stagnation does not help.

I would just say, finally, I was struck by the hosannas—to stay with the religious motif—which greeted the fact that we created 146,000 new jobs last month. That is way below every projection this administration had made.

I am giving out a sheet here called "The Evolution of Diminishing Expectations." And what it shows is, the administration has finally met its job projection figures—by lowering them.

The Council of Economic Advisers in 2003 said we would get 305,000 jobs a month. Secretary Snow in October of 2003 said we would get 200,000. He was lowballing. Then the council went back up to 325,000. That was the last one before the election. They projected 325,000 jobs a month. Then it dropped to 175,000 jobs a month.

In fact we have never made, over any prolonged period, any of those projections. We have not hit 200,000 jobs a month.

So job creation has been stagnated. Unemployment has dropped largely, as Paul Krugman pointed out——

And I ask unanimous consent to put his Monday column in the record.

The CHAIRMAN. Without objection.

Mr. FRANK.—largely because the participation rate is declining in the economy.

So, as you say in the report, there is still slack in the labor market. That is holding down wage costs; i.e., people are not getting increases in wages, health care for those who are employed is eroding.

And so people see this growth and do not see that they are getting a part of it, and that is why you get this "resistance" that you mentioned.

So when we get to the question period I will ask you what you think we can do about that.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from New York, Ms. Maloney, is recognized for 3 minutes for opening statement.

Mrs. MALONEY. Welcome, Mr. Greenspan.

As always, it is a pleasure to hear your testimony—all 35 times.

You have served, more than any other person, as our country's captain of monetary policy. You have guided us through economic growth, recession, and into globalization.

In serving our country, you have often spoken out strongly against positions that you disagree with. So I find it very surprising that you are not strongly criticizing the ballooning deficits this administration has foisted on the American people.

The Bush legacy is the largest national debt in history. The Republican Congress and president inherited a surplus, yet they have voted three times to raise the debt ceiling.

We now have a record debt of over $7.5 trillion, the largest in history; and this breaks down to each citizen's share being over $26,000.

We also have the largest trade deficit in our history, supported by the willingness—at least so far—of foreign investors and governments to keep extending us credit. We have the largest percentage of foreign holders of U.S. debt ever.

We keep being told that the administration is going to fix this, but nothing is happening. Just last week the administration announced that the federal budget deficit for this year will not be as large as they were predicting it would be in January.

Republicans are taking this as some kind of evidence of a supply-side miracle in which the president's tax cuts are actually creating large increases in revenue.

And surely a man of your reputation, or anyone who actually read the OMB Mid-Session Review, is not going to take it as evidence of any real change in the structural budget deficit picture.

As analysts at Goldman Sachs and in other places have pointed out, this year's large increase in tax receipts stems from temporary factors that are unlikely to be repeated, including the expiration of the tax cut on business investment.

CBO Director Holtz-Eakin, a former Bush administration economist, has made the same point about the temporary nature of the revenue surge, saying that once you go out to 2008 and 2010, things look about the same as they did before we found out about this year's jump in revenues.

The administration, in my opinion, is trying to distract us from the long-term budget problems they have created with irresponsible policies.

But the American people deserve to know the truth, and surely you, of all people, Mr. Greenspan, should be speaking out about this.

You were part of the team that helped the Clinton administration balance the budget, you were part of the team that helped build the surplus, and you know it can be done.

The American people are absolutely being skewered with this crushing debt that will affect them and the lives of their children, their grandchildren, their quality of life.

I really would hope that today and in the future you will take a stand against spending the American people into a hole that is very difficult to get out of and very painful to get out of, and I wish that you would speak out as strongly on this issue and as forcefully on this issue as you have on others.

The CHAIRMAN. The gentlelady's time has expired.

The gentlelady from Ohio, Judge Pryce?

Ms. PRYCE. Thank you, Chairman Oxley.

Welcome, Chairman Greenspan. Thank you for taking time to discuss with us your insightful thoughts on monetary policy and the state of our economy.

I am pleased to read in your testimony that you believe overall the economy remains steady. Many financial analysts have credited the strong, vibrant housing market as a vital segment of the health of our economy.

Recent studies have found that housing accounted for more than one-third of economic growth during the previous 5 years.

Many observers, including yourself, have noted that mortgage refinancing provided crucial support to the economy during the past recession, enabled homeowners to reduce their debt burdens and maintain adequate levels of consumer spending by tapping into the equity of their homes. I for one took great advantage of that.

Despite these latest gains in home ownership, I am concerned about the recent surge in home prices in many metropolitan areas. In most countries, the recent surge in home prices has gone hand in hand with a much larger jump in household debt than in previous booms.

Not only are new buyers taking out bigger mortgages, but existing owners have increased their mortgages to turn capital gains into cash that they can spend.

So I hope to hear your views on the current status of this country's housing market and whether a nationwide bubble exists, also what effect a measured rise in inflation will have on the housing market.

As we have seen in the Australian economy, they experienced a surge and were able to slowly raise rates and control real estate speculation, keeping that economy healthy after the market peaked.

So I look forward to talking more about that with you.

Shifting gears, I would also like to know—and I will ask later—whether you feel the recent string of data security breaches has affected consumer confidence in our payment systems.

As you know, Mr. Chairman, I, along with many of my colleagues on both sides of the aisle here, are working hard on some legislation that will provide uniform national standards for consumer protection and data breach notification, and we would appreciate any insights you care to share.

Data security breaches are something that all of us are concerned with, as we see more and more instances of breaches in the headlines every day.

I am pleased to be working with many members, Congressman Castle and LaTourette, Moore, Hooley, even Mr. Frank, on these important issues.

And we appreciate the leadership of Chairman Oxley and Chairman Baucus as well.

But under Gramm-Leach-Bliley, financial services firms already have an obligation to keep consumer information secure and confidential, and we need to extend those safeguards to information brokers and others.

When a breach occurs that could lead to financial fraud or misuse of sensitive financial identity information, customers have the right to be informed about the breach and what steps they should take to protect themselves.

I believe there should be one federal standard for data security and for notification. Disparate standards that vary from state to state are an administrative nightmare and make compliance very difficult.

Varying standards can cause consumer confusion, and customers should be assured that when their information is breached, they receive the same notification no matter where they live.

So, thank you, Mr. Chairman, for your appearance today. I look forward to your testimony.

And thank you, Chairman Oxley.

I yield back.

The CHAIRMAN. The gentlelady yields back.

We now turn to our distinguished chairman of the Fed.

Chairman Greenspan, again, welcome back to the committee.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, FEDERAL RESERVE BOARD

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

I have a rather extended formal presentation and would request that it be included for the record, and I will excerpt from that.

The CHAIRMAN. Without objection.

Mr. GREENSPAN. Mr. Chairman and members of the committee, I am pleased to be here to present the Federal Reserve's Monetary Policy Report to the Congress. I am surprised to hear it is the 35th time.

In recent weeks, employment has remained on an upward trend; retail spending has posted appreciable gains; inventory levels have been modest; and business investment appears to have firmed. At the same time, low long-term interest rates have continued to provide a lift to housing activity.

Although both overall and core consumer price inflation have eased of late, the prices of oil and natural gas have moved up again, on balance, since May and are likely to place some upward pressure on consumer prices, at least over the near term. Slack in labor and product markets has continued to decline.

In light of these developments, the Federal Open Market Committee raised the federal funds rate at its June meeting to further reduce monetary policy accommodation. That action brought the

cumulative increase in the funds rate over the past year to 2.25 percentage points.

Should the prices of crude oil and natural gas flatten out after their recent runup, the forecast currently embedded in futures markets, the prospects for aggregate demand appear favorable.

Household spending, buoyed by past gains in wealth, ongoing increases in employment and income, and relatively low interest rates, is likely to continue to expand.

Business investment in equipment and software seems to be on a solid upward trajectory in response to supportive conditions in financial markets and the ongoing need to replace or upgrade aging high-tech and other equipment.

Moreover, some recovery in non-residential construction appears in the offing, spurred partly by lower vacancy rates and rising prices for commercial properties.

However, given the comparatively less buoyant growth of many foreign economies and the recent increase in the foreign exchange rate of the dollar, our external sector does not seem poised to contribute steadily to U.S. growth. A flattening out of the prices of crude oil and natural gas, were it to materialize, would also lessen upward pressure on inflation.

Thus our baseline outlook for the U.S. economy is one of sustained economic growth and contained inflation pressures.

In our view, realizing this outcome will require the Federal Reserve to continue to remove monetary accommodation. This generally favorable outlook, however, is attended by some significant uncertainties that warrant careful scrutiny.

With regard to the outlook for inflation, future price performance will be influenced importantly by the trend in unit labor cost, or its equivalent, the ratio of hourly labor compensation to output per hour.

Over most of the past several years, the behavior of unit labor costs has been quite subdued. But those costs have turned up of late, and whether the favorable trends of the past few years will be maintained is unclear.

Hourly labor compensation as measured from the national income and product accounts increased sharply near the end of 2004. However, that measure appears to have been boosted significantly by temporary factors.

Over the past 2 years, growth in output per hour seems to have moved off the peak that it reached in 2003. However, the cause, extent and duration of that slowdown are not yet clear.

Energy prices represent a second major uncertainty in the economic outlook. A further rise could cut materially into private spending and thus damp the rate of economic expansion.

Judging from the high level of far-future prices, global demand for energy apparently is expected to remain strong, and market participants are evidencing increased concerns about the potential for supply disruption in various oil-producing regions.

More favorably, the current and prospective expansion of U.S. capability to import liquefied natural gas will help ease longer-term natural gas stringencies and perhaps bring natural gas prices in the United States down to world levels.

The third major uncertainty in the economic outlook relates to the behavior of long-term interest rates. The yield on 10-year Treasury notes, currently near 4.25 percent, is about 50 basis points below its level of late spring 2004.

This decline in long-term rates has occurred against the backdrop of generally firm U.S. economic growth, a continued boost to inflation from higher energy prices, and fiscal pressures associated with the fast-approaching retirement of the baby-boom generation.

The drop in long-term rates is especially surprising given the increase in the federal funds rate over the same period. Such a pattern is clearly without precedent in our recent experience.

Two distinct but overlapping developments appear to be at work: a longer-term trend decline in bond yields; and an acceleration of that trend of late.

Some, but not all, of the decade-long trend decline in that forward yield can be ascribed to expectations of lower inflation, a reduced risk premium resulting from less inflation volatility, and a smaller real-term premium that seems due to a moderation of the business cycle over the past few decades.

This decline in inflation expectations and risk premiums is a signal development.

As I noted in my testimony before this Committee in February, the effective productive capacity of the global economy has substantially increased, in part because of the breakup of the Soviet Union and the integration of China and India into the global marketplace; and this increase in capacity in turn has doubtless contributed to expectations of lower inflation and lower inflation-risk premiums.

In addition to these factors, the trend reduction worldwide in long-term rates surely reflects an excess of intended savings over intended investment. This configuration is equivalent to an excess of the supply of funds relative to the demand for investment.

What is unclear is whether the excess is due to a glut of savings or a shortfall of investment. Because intended capital investment is to some extent driven by forces independent of those governing intended saving, the gap between intended saving and investment can be quite wide and variable.

It is real interest rates that bring actual capital investment worldwide and its means of financing global savings into equality. We can directly observe only the actual flows, not the savings and investment tendencies.

Nonetheless, as best we can judge, both high levels of intended savings and low levels of intended investment have combined to lower real long-term rates over the past decade.

Since the mid 1990s, a significant increase in the share of world gross domestic product produced by economies with persistently above-average savings, predominantly the emerging economies of Asia, has put upward pressure on world savings.

These pressures have been supplemented by shifts in income toward the oil-exporting countries, which more recently have built surpluses because of steep increases in oil prices.

Softness in intended investment is also evident. Although corporate capital investment in the major industrial countries rose in recent years, it apparently failed to match increases in corporate cash flow.

In the United States, for example, capital expenditures were below the very substantial level of corporate cash flow in 2003, the first shortfall since the severe recession of 1975.

That development was likely a result of the business caution that was apparent in the wake of the stock market decline and the corporate scandals early this decade.

Japanese investment exhibited prolonged restraint following the bursting of their speculative bubble in the early 1990s; and investment in emerging Asia, excluding China, fell appreciably after the Asian financial crisis in the late 1990s.

Whether the excess of global intended saving over intended investment has been caused by weak investment or excessive savings—that is, by weak consumption—or, more likely, a combination of both does not much affect the intermediate-term outlook for world GDP or, for that matter, U.S. monetary policy.

What have mattered in recent years are the sign and the size of the gap of intentions and the implications for interest rates, not whether the gap results from a saving glut or an investment shortfall.

That said, saving and investment propensities do matter over the longer term. Higher levels of investment relative to consumption build up the capital stock and thus add to the productive potential of an economy.

The economic forces driving the global saving-investment balance have been unfolding over the course of the past decade, so the steepness of the recent decline in long-term dollar yields and the associated distant forward rates suggests that something more may have been at work over the past year.

Inflation premiums in forward rates 10 years ahead have apparently continued to decline, but real yields have also fallen markedly over the past year.

Risktakers apparently have been encouraged, by a perceived increase in economic stability, to reach out to more distant time horizons. These actions have been accompanied by significant declines in measures of expected volatility in equity and credit markets.

History cautions that long periods of relative stability often engender unrealistic expectations of its permanence and at times may lead to financial excess and economic stress. Such perceptions, many observers believe, are contributing to the boom in home prices and creating some associated risks.

And certainly the exceptionally low interest rates on 10-year Treasury notes, and hence on home mortgages, have been a major factor in the recent surge of home building, home turnover, and particularly in the steep climb in home prices.

Whether home prices on average for the nation as a whole are overvalued relative to underlying determinants is difficult to ascertain, but there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels.

Among other indicators, the significant rise in purchases of homes for investment since 2001 seems to have charged some regional markets with speculative fervor.

The U.S. economy has weathered such episodes before without experiencing significant declines in the national average level of

home prices. Nevertheless, we certainly cannot rule out declines in home prices, especially in some local markets.

If declines were to occur, they likely would be accompanied by some economic stress, though the macroeconomic implications need not be substantial.

Historically, it has been rising real long-term interest rates that have restrained the pace of residential building and have suppressed existing home sales, high levels of which have been the major contributor to the home equity extraction that arguably has financed a noticeable share of personal-consumption expenditures and home-modernization outlays.

The trend of mortgage rates or long-term interest rates more generally is likely to be influenced importantly by the worldwide evolution of intended saving and intended investment.

We at the Federal Reserve will be closely monitoring the path of this global development few, if any, have previously experienced.

As I indicated earlier, the capital investment climate in the United States appears to be improving following significant headwinds since late 2000, as is that in Japan. Capital investment in Europe, however, remains tepid.

A broad worldwide expansion of capital investment not offset by rising worldwide propensity to save would presumably move real long-term interest rates higher. Moreover, with term premiums at historical lows, further downward pressure on long-term rates from this source is unlikely.

We collectively confront many risks beyond those I have mentioned. As was tragically evidenced again by the bombings in London earlier this month, terrorism and geopolitical risk have become enduring features of the global landscape.

Another prominent concern is the growing evidence of antiglobalization sentiment and protectionist initiatives, which if implemented would significantly threaten the flexibility and resilience of many economies.

This situation is especially troubling for the United States, where openness and flexibility have allowed us to absorb a succession of large shocks in recent years with only minimal economic disruption. That flexibility is, in large measure, a testament to the industry and resourcefulness of our workers and businesses.

But our success in this dimension has also been aided importantly by more than two and a half decades of bipartisan effort aimed at reducing unnecessary regulation and promoting the openness of our market economy.

Going forward, policymakers will need to be vigilant to preserve this flexibility, which has contributed so constructively to our economic performance in recent years.

In conclusion, Mr. Chairman, despite the challenges I have outlined and the many I have not, the U.S. economy has remained on a firm footing, and inflation continues to be well contained. Moreover, the prospects are favorable for a continuation of those trends.

Accordingly, the Federal Open Market Committee in its June meeting reaffirmed that it believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects, as needed, to fulfill its obligation to maintain price stability.

Thank you very much.

I look forward to your questions.

[The prepared statement of Hon. Alan Greenspan can be found on page 53 in the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman.

And of course I think it is appropriate that your final appearance before the committee ended with price stability, because indeed, as you have indicated at least 35 times before this committee, that ultimately is the charge of the Fed—and you have performed extraordinarily well.

I mentioned in my opening statement the fact that it appears now that federal revenues for the first quarter of this year have caused a lowering of the expected size of the budget deficit, perhaps as much as $100 billion.

The evidence would indicate that most of that revenue came from capital gains and dividend taxes—and, at least in most quarters, is greeted with a lot of favor.

Has the Laffer Curve come back or is this a temporary phenomenon that may be different, say, in the current quarter?

Mr. GREENSPAN. Well, certainly, Mr. Chairman, dividends are higher; and indeed, to that extent, the overall general outlook for profitability has clearly had a substantial impact on the revenues to which you allude.

It is too soon to actually make judgments about exactly where those revenues are coming from. We do know it is non-withheld, we do know it is corporate taxes, and we are even getting some in the withheld area.

So it is a fairly broad expansion which does relate directly to the level of economic activity, which does seem to be expanding at a reasonably good pace.

Now, we will not know in full detail until we get the statistics of income—which is often, of course, quite late—to get the full detail of exactly what is happening.

But I would say that, as I have indicated on many occasions, I do think that the particular characteristic of recent taxation, which has eliminated part of the double taxation of dividends, has contributed to economic growth.

We do not know that yet, and we will not know that for a number of years, because it is only in retrospect that we will be able to make that judgment fully.

But at least I would say that is my impression, or at least I cannot see anything which contradicts that at this particular moment.

The Laffer Curve is a much broader question, which I do not think I have time to discuss. But in general I must say I am pleased with the revenue increases that have occurred because it is a reflection of an economy which is doing well.

The CHAIRMAN. I just threw that "Laffer Curve" in as kind of an enticement, to get your attention.

[Laughter.]

Let me ask you about this. When you were here in February you indicated the need to basically migrate our Social Security system toward individual accounts, particularly as it related to capital formation and giving us the ability to have the capital necessary to keep our economy strong and create jobs and growth.

Have you had any different ideas or change of mind since February?

Mr. GREENSPAN. No, but I think it is worthwhile reviewing where we are relative to this issue.

We know, with as high a level of certainty as you ever can gather, that we are going to get a very substantial acceleration in the number of retirees in this country starting in 2008; but we also know that the next generation coming in behind the baby boomers is much smaller, which means that the working labor force is going to grow at a relatively small, a very small, rate.

This means that we are going to have a very substantial amount of people not productive, in the way they had been when they were in the workforce, essentially being supplied with goods and services by a labor force which is growing rather slowly.

It is very difficult to convey how important it is when you take as productive a group of people coming out of the baby-boom generation—and they are now in their most productive years—and you move that group into retirement. Its impact is very substantial.

But the major point I want to make is that Social Security has over the years, largely because of the demographics that we have observed in recent generations, been able to replace roughly 40 percent of the incomes that workers had prior to retirement.

It strikes me that it is going to be very difficult to deliver that in real terms because of the extraordinary demographic shift which we are about to experience.

But it is certainly also going to be the case that retirees are going to need something like 80 percent of their immediately preretirement income to maintain a reasonable standard of living, and that means a very substantial part of retirement resources is going to come from other than Social Security, of necessity; and that inevitably means private pension funds, defined benefit, 401(k)s, personal savings, other forms of income, and I suspect that we will require fairly significant expanding forms of private savings initiatives.

And one of the reasons why I have been supportive of moving a significant part of Social Security toward private accounts is to develop that particular process.

I have nothing, basically, new to say on the issue than what I discussed with you in February.

The CHAIRMAN. Thank you, Mr. Chairman.

My time has expired.

The gentleman from Massachusetts?

Mr. FRANK. Thank you, Mr. Chairman.

I do have to note one further example, among many, of your discretion, when the chairman asked you about the Laffer Curve.

You said—it was fairly early in his 5 minutes—that you did not have the time to answer it. There is an old, crude joke: "Do you have the time?" "Well, if you have the inclination."

My inference, frankly, is that you had the time but not the inclination. I honor that, and I understand it. I think it is very discreet.

I want to go back to the point I raised before, and that is—and I agree with you, we have this resistance to many of the measures that have been helpful, that I think would be helpful. I may disagree on some. And we have had a bipartisan cooperation in many

of these areas, going back to President Carter and others, who did deregulation.

But people need to understand, people in the business community need to understand, that bipartisan cooperation is breaking down in the economic area—and I am not talking about bickering or squabbling; I am talking about profound philosophical differences.

Many of us are convinced that we are in a situation now, because of information technology, globalization, and a lot of other factors which are, in many ways, benign, but they combine so that we are getting increased growth with increased inequality.

You yourself have commented on this trend. You told the Joint Economic Committee over a year ago that a substantial part of the increased wealth and productivity was going to corporate profits.

In fact, what you said was that—this is a little over a year ago: "The consequence was a marked fall in the ratio of employee compensation to gross non-financial corporate income to a very low level by the standards of the past 3 decades." Now, we had unemployment, but people are celebrating a decline in unemployment.

But reading Paul Krugman's article in July, my attention was called to a policy paper done of the Boston Federal Reserve, by Katharine Bradbury.

And you are justly proud, I know, of the high-quality work that is done by your analysts. I do not know if you have had a chance to look at this one. It is a fairly recent policy brief.

But her point is very straightforward: "Decrease in unemployment is substantially because of a decrease in the labor participation rate. Improvements in the unemployment rate overstate the strength of the recovery, since the nation's labor force participation rate has not rebounded to date."

Even after job counts began to rise and joblessness subside, however, the fraction of the population that is employed did not increase, and it has not improved measurably to date.

And that also, of course, is one of the reasons why we have not seen any increase in wages. And you noted in 2004 that wages were depressed. You have said yes, the wage sector is going up.

But again, as your Monetary Report—and I am consistently grateful for the intellectual honesty and clarity of these reports—that is largely because of stock options and bonuses, so that people working for hourly wages——

And I am going to ask to put in the record here a chart that Mr. Morris on my staff has prepared from Department of Labor, Department of Commerce data. Real wages, average hourly earnings for production and non-supervisory workers, adjusted for inflation, 2001, $14.52. As of June of this year, $14.05: a 47-cent-per-hour decrease.

Now, it is one thing for people to experience a decrease when they read about bad economic times; it is another when they read celebrations of how well the economy is doing but they are not doing well.

That, to me, is the explanation for the phenomenon you deplored in your statement, about the "growing resistance."

Why do you think we are running into this growing resistance? Would you agree, or do you have some other explanation? I mean, do workers suddenly turn mean and surly or what?

Mr. GREENSPAN. Congressman, first let me just say that we at the board do have some questions about that Boston Federal Reserve study.

Very specifically, it fails to take into consideration, in our judgment, certain important structural changes, such as the fact that in early years we had an extraordinarily rapid rise in participation in the labor force of adult women. We finally got to the point when it would flatten out——

Mr. FRANK. Let me withdraw that, then.

But I would be interested, subsequently: Why do you think we are encountering this resistance, this potential threat to the bipartisan consensus for flexibility?

What do you think the reason is?

Mr. GREENSPAN. I think the reason is basically that we are developing a bivariate labor market, as I have indicated in previous periods, and I think I did in February testimony here.

We have an oversupply of high-skill jobs and an undersupply of people to fill them, the effect of which is to create a significant acceleration in average incomes of the highly-skilled segment of our labor force.

And that, as you recall, I attribute to the fact that we have been unable in our educational institutions to move our younger people sufficiently quickly from grade 4 through high school, into college and beyond, at a pace which would create an adequate supply of the number of skilled workers which we need—which, incidentally, would bring the wage increases down—but also simultaneously remove an excess of lesser-skilled workers, which are depressing——

Mr. FRANK. I understand. But we have got the people—as you and I understand, that is for the future.

We have got tens of millions of people who are beyond the educational stages. How do you deal with that? What is your——

Mr. GREENSPAN. Well, I was basically saying that the reason that a substantial part of our labor force feels as though it is not getting the benefits of the increased production is essentially a function, in my judgment, of problems in our educational system.

Mr. FRANK. First of all, I would just quibble with "feels as though." There has been a drop in their real wages.

Secondly, though: We could agree on improving the educational system, but there are people in their 30s and 40s and 50s who are very, very unlikely to be affected by that. What do we do about them?

Mr. GREENSPAN. No, I——

Mr. FRANK. Because if you do not do anything about them, you will continue to complain about this rise in resistance—because it is not that they "feel" it, it is that that they are in fact experiencing it.

Mr. GREENSPAN. Yes. First of all, I do not envisage our education system as one which takes young people, graduates them, and they never see school again.

As you well know, better than I, our community colleges have very substantial enrollment, and indeed they are the most rapidly

growing part of our educational system, and they are predominantly people——

Mr. FRANK. Paid for with tax dollars, government entities——

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from Ohio?

Ms. PRYCE. Thank you, Mr. Chairman.

Mr. Chairman, if you do not mind, let us talk about data breach for a little bit, and I would really appreciate your insight as to how it has been affecting consumer confidence and to what effect.

As we pursue some legislation here in this committee, do you agree we should have a national standard?

I would appreciate any thoughts or——

Mr. GREENSPAN. National standards on what?

Ms. PRYCE. On what constitutes a breach or anything—a national standard on any portion of legislation that would come out of this committee, what we should do, what we should not do.

We do not want to make a situation that is pretty terrible, with implications that I believe are staggering, in terms of identity theft and misuse of other people's credit and—we have to proceed cautiously, and I am just looking for you to help us here.

Mr. GREENSPAN. Yes. It is a very tough and, frankly, discouraging issue.

We obviously have equivalent issues at the Federal Reserve in protecting our information, and what we have tended to do is create redundancies in our mechanisms and procedures so that in the event that certain structures fail, we have ones that can come up and create support.

That is expensive, and the problem that we are always trading off on all of these types of issues is how much risk, how much loss, how much disruption are we willing to accept as a minimum? Because we could eliminate that completely, but at a very significant cost.

I am not sure I could add very much to your judgments with respect to what type of legislation, how it would be done.

I am quite familiar with encryption capabilities and a variety of other issues that we employ.

But when we are dealing with shipments of millions of names going all over the country, either electronically or in the back of trucks, something is going to drop off the back of the truck, and the only way to avoid that is to double up on efforts.

There is no simple solution. There is probably no cost-free solution. And I think it is a tough judgment to make, as to how far you want to bring that issue to the forefront.

I cannot judge because I am not familiar with the individual natures of the problems that clearly show up in the newspapers periodically, to my chagrin.

Ms. PRYCE. Well, as we go, you know, the payment system from cash and checks to more a credit base, credit cards and debit cards, I think we have to address this as a government, and we do want to proceed cautiously.

The consumer confidence issue is one that I can see severely affecting our economy.

Mr. GREENSPAN. Yes. Fortunately, we have not yet seen any impact on national consumer confidence from any of these issues.

But it should not be an issue of consumer confidence; it should be an issue of doing something which is important for protecting consumers.

Ms. PRYCE. That is correct.

All right. I appreciate the gentleman's candor on that and look forward to working with you.

And I yield back.

The CHAIRMAN. Gentlelady yields back.

The gentlelady from California, Ms. Waters?

Ms. WATERS. Thank you very much, Mr. Chairman and members.

I would like to thank Mr. Greenspan for being here on this Monetary Policy Report to Congress.

I know that when you come, we utilize this as an opportunity to ask you about all things we are concerned about, that we think you have some information on.

As you know, we are going to be involved with a vote here in another week or so, perhaps, on CAFTA.

The arguments for CAFTA are ones that, of course, you are very familiar with—may have even led on, I am not sure—that talk about how this will help us to reduce the trade deficit and how we can perhaps get the manufacture and production of cheap goods and products, that will cause our businesses to be able to profit because of the reduction in costs, that some of us are concerned about the outsourcing or the jobs that go offshore because we think that these jobs are very important to our own citizens, and even those jobs that do not pay huge wages.

There are some people, whom you correctly identified or alluded to, who may not have benefited from our educational system in ways that they should; but they deserve to have a job also, and to work, and to have a decent quality of life.

I do not know where you stand on CAFTA. I would like to hear what you think.

How do we benefit from the passage of CAFTA?

Mr. GREENSPAN. CAFTA is part of a broader issue of the extent to which we, the United States, want to engage in globalization.

Globalization has two aspects to it, as best I can judge. One, it undoubtedly enhances standards of living worldwide, and indeed those economies that engage in international trade have invariably been boosted—and this has been especially the case since the end of World War II, and the United States has probably been the economy which has benefited the most.

That process, however, of globalization is one of creative destruction in the sense that we are continuously competing and, in the process, we increase standards of living by essentially moving the depreciation from obsolescent facilities to cutting-edge equipment.

And in fact, it is the difference between the two's productivity where standards of living come from. But that process is very disruptive, and indeed it is associated with a very large turnover of the labor force.

As I have mentioned here previously, we hire in this country 1 million workers a week, and indeed people lose jobs in very large volumes every week as well. There is a large churning that goes on.

To the extent we wish to secure jobs, to the extent that we wish to secure businesses from this competition, it will increase a sense of security, but it will do so at the expense of a lower standard of living.

And the choice the Congress has to make—because indeed it is the Congress which makes these valued choices for the American people—is: To what extent do we wish to engage in international trade—of which CAFTA is just merely one aspect of it—with its churning, with its insecurities, but with its higher standards of living, or to what extent do we prefer a more tranquil, protected type of a society? And this is a very difficult judgment.

I personally have argued very strenuously that I think that the globalization route is by far the superior route, because protection may appear to be helpful in the short run, but over the long run you cannot protect industries or jobs which are obsolescent.

And I think that what we have to do is to move forward, as best we can, in globalization but to recognize that those who are the inevitable losers in this churning process be protected in some form—in other words, to address, either through retraining or other means, that there are losers in this process, and we should, as a civil society, endeavor to find means to recognize that fact.

The CHAIRMAN. The gentlelady's time has expired.

Ms. WATERS. Thank you.

The CHAIRMAN. The gentleman from Iowa, Mr. Leach?

Mr. LEACH. Thank you very much.

An analog to this discussion. Your former colleague at the Federal Reserve, Mr. Bernanke, has emphasized that there is a savings glut in the Far East and a savings paucity here.

In your statement today you have noted that in the Middle East savings has gone up to about a third of GDP. So there implicitly is a savings glut in the Middle East.

Do you have any advice to these two regions—and it could be quite separate—on what should be done with this savings?—particularly if it is different than is currently being managed.

Mr. GREENSPAN. Well, you are sort of putting me in a position to advise large segments of the world about what they ought to do. I appreciate that.

[Laughter.]

Mr. LEACH. Well, the Federal Reserve has the capacity to bail out large segments of the world——

Mr. GREENSPAN. I would point out, however, in my prepared remarks I do raise an issue—which I think is an important issue, sir—about the question of the geographical location of crude oil reserves being relatively concentrated; and that means that the productive capacity—that is, the conversion of those reserves into the capability of lifting crude oil—requires a very significant amount of capital investment and that the vast majority of these oil-producing countries do not look favorably upon foreign investment because they consider their experiences in the past to be undesirable in that regard.

And yet because these are growing populations in these oil-producing areas, they perceive the need for the revenues that are coming from the oil production to go to domestic needs and not in any substantial extent to be reinvested to increase crude oil capacity on

the reserves that they already have; and it strikes me that we are in a position where world oil demand is rising and is rising at a pace which is going to require significant amounts of capital investment.

And how that is essentially resolved, whether the resources of international oil companies or others to invest in productive capacity in these areas is allowed—I mean, for example, in Mexico, as I am sure you know, there is a constitutional amendment which prohibits international, foreign investors engaged in that resource, and Pemex, the national oil company in Mexico, is pressuring to see if that prohibition could be reduced, because they perceive the need for the capital and the expertise to drill in areas in deep waters in the Gulf of Mexico where they know significant amounts of oil are available.

So it is a very difficult question. So far as emerging Asia is concerned, they seem to be doing quite well, and in my judgment, will eventually resolve that question of their excess flow of savings.

Mr. LEACH. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from New York, Ms. Maloney?

Mrs. MALONEY. Thank you, Mr. Chairman.

Chairman Greenspan, last week the administration issued its Mid-Session Review of the budget, showing that the deficit in 2005 will be lower than we thought it would be back in January.

My question is: Do you agree with analysts, like those at Goldman Sachs, who point out that much of the improvement in 2005 comes from temporarily-high corporate profits and the expiration of the temporary tax cut on business investment?

Mr. GREENSPAN. Oh, I think that is correct, but I think OMB recognizes that as well.

Mrs. MALONEY. And so then you do agree with the former CBO director, Holtz-Eakin, that once you go out a few years, the budget outlook is about the same as it was in January?

Mr. GREENSPAN. I am not sure about that, and the reason, basically, is that we can disaggregate revenues and we can make adjustments for what we perceive to be the cause of this surge, at least on the individual side, which is increased bonuses and presumably a significant increase in exercise of stock options as well as capital gains realizations.

But even after you account for that, you have unknown changes that are going on, the so-called technical adjustment—which is what, for example, Treasury uses to translate its forecasts of taxable income into taxable receipts. As I mentioned earlier, we really will not have a good insight into the sources of these revenue increases this year until we see the statistics of income, which are published, a couple of years from now. So we really will not know until we look backwards.

I do think anybody who is projecting from here forward with respect to revenues is confronted with some significant elements of uncertainty. But I would not necessarily say that either the longer-term views that the most recent revenues are wholly temporary or those who believe that the revenues will continue at the same levels are probably correct.

The answer is probably somewhere in the middle.

Mrs. MALONEY. So your answer is: Yes, probably yes. Correct?

Mr. GREENSPAN. I am sorry, "yes" is what?

Mrs. MALONEY. Probably "Yes" for both the Goldman Sachs and the CBO director?

Mr. GREENSPAN. No, not necessarily. I would say that yes, that it is probably in between where OMB is and Goldman Sachs, if I had to guess. But it is a guess.

Mrs. MALONEY. Okay.

Mr. Greenspan, is there sufficient strength in the labor market to justify the continued rate hikes?

And I would like to cite that after the 2001 recession, this was followed by really the most protracted job slump we have seen since probably the 1930s. And was it not common in the expansion of the 1990s, for example, to see payroll employment growth of over 200,000 jobs per month, and has it not been rare to see that kind of job growth in this economy?

And I am sure that you are familiar with the study that has been cited recently by Katharine Bradbury of the Federal Reserve Bank of Boston, calling attention to how the labor force participation rate has not recovered as it usually does in an economic expansion; and does not that raise questions about whether there is some hidden unemployment not being captured in the official unemployment rate?

And finally, wage growth has not kept up with inflation, and most of the productivity gains achieved over this expansion have gone into profits and not into the wages of the working men and women of this country; and my main question is: Does the Fed take into account all this evidence that there may still be a considerable slack in the labor market when it decides whether or not to keep raising interest rates?

Mr. GREENSPAN. Well, Congresswoman, let me say, as I was mentioning to Congressman Frank: That Boston study presumes that 1 to 3 percentage points of the decline in the participation rate is as a result implicitly of the conditions you are suggesting.

We at the board, doing similar type of analysis but addressing it somewhat differently, believe that the number is actually less than a half a percent; and that is strictly a technical issue, that we think certain calculations that were made at the Boston Fed inadequately captured what was going on.

Having said that, let me just go further with respect to: It is the case that the 80 percent of our workforce which are production workers do have a very slow rate of growth in average hourly earnings, real and even nominal, in that respect.

One of the reasons—other than the issue that I raised earlier; namely, the educational question and the skill and the imbalances—is that the benefit levels have gone up very substantially, and what tends to happen, as best that we can judge, is that ultimately benefits are paid by the employee and that if benefits go up the way labor market pressures tend to work, the aggregate package is what is determined in the markets, and it is essentially the individual workers who, over the long run, determine what the mix is.

I think that there is a really serious problem here, as I have mentioned many times before this committee, in the consequent

concentration of income that is rising as a result of what is a very obvious case of a major requirement to increase the skill level of the capital stock which we need to move forward and maintain high levels of productivity and the supply of workers that we create to essentially staff that capital stock. And the reason that we are getting this very disparate earning pattern is—and I will repeat again—where something is deficient, at least in an international context, of how we deal with our workforce as they come out of school or, more exactly, as they move through the educational system.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from Alabama?

Mr. BACHUS. I thank the chairman.

Chairman Greenspan, on Page 5 of your report there is a chart on personal savings. I also read a recent report by the American Institute of Certified Public Accountants that says because of the decline in personal savings America is on a collision course with disaster.

Is that an overstatement or——

Mr. GREENSPAN. Yes, sir.

[Laughter.]

Mr. BACHUS. All right. Good.

How serious is it? And let me ask you this. We hear figures—the Department of Commerce recently made a statement that Americans are spending $1.22 for every dollar they earn; yet we hear that personal savings rates are 0.5 percent of disposable income, or 3 percent. They are obviously below the 8 percent or 12 percent or 10 percent rates.

But how serious is the problem of decline in personal savings rates?

Mr. GREENSPAN. It is difficult to tell. I think one of the issues here is to distinguish between what households perceive they are saving, and if you survey them, they are perfectly satisfied; and the reason that they are satisfied and these numbers look very low is that they are two different measures.

The average household, when the value of their 401(k) goes up or they are holding stocks that go up, see their net worth go up, and as far as they are concerned, they are pleased by it; however, for national income accounting—which is basically what this personal savings rate endeavors to capture—you have to extract all capital gains out of the system.

While an individual who has just, say, sold a home or some stock and has got real cash, they do not distinguish between whether they got that from wages and salaries or from capital gains. It is purchasing power, and that is savings, as far as they are concerned.

But, without getting into the economics of this, capital gains do not finance capital investment. Only savings, at its book value, if I may put it that way, do that. And as a consequence, we have reasonably high capital investment in this country, but we do not have enough domestic savings and personal savings as part of that to finance it.

A significant part of our investments are, as you know, financed by borrowing from abroad, and that is our current account deficit.

So in the sense that we do not have adequate domestic savings and we cannot count indefinitely that we will be able to borrow at the rate we are borrowing from abroad, clearly, then, our savings rate is inadequate, and we must address that over the longer run.

Mr. BACHUS. And you have said earlier today that the baby boomers beginning to retire is simply going to accelerate this decline in personal savings rate?

Mr. GREENSPAN. I would think that will be the case, yes.

Let me just say parenthetically: I do not expect that the personal savings rate will stay down this low indefinitely. Part of it is related to the fact that there is a very significant amount of extraction of equity from homes in this country financed by mortgage debt.

Since the debt which is employed in doing that is a subtraction from savings, you will find that that is a major factor creating the low level of savings; and when equity extraction slows down, as eventually it will at some point, I think you will find this personal savings rate starting back up.

Mr. BACHUS. Now, you mentioned some other concerns about this. One was federal spending and the amount of the federal deficit. So obviously one thing that we in Congress could do would be: try to reduce federal spending. Is that——

Mr. GREENSPAN. That would be most helpful. And indeed I have testified before this committee on numerous occasions, as well as other committees in the House and Senate, that this is a critical aspect of the long-term planning of this country and that, unless we address that issue I think we are in potentially serious difficulty as we move into the next decade.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from New York, Ms. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Chairman Greenspan, the recent suicide bombings in London highlight the growing threat that terrorism plays in our society. From an economic perspective, the London bombings will only add to the government's investment in security.

The federal government is set to spend over $30 billion on homeland security, while it is estimated that private sector expenditures for homeland security may double from pre-2001 levels to over $100 billion per year.

The threat of terrorism has clearly changed the spending priorities of government at all levels and businesses across the country. No one can argue with the goals of this investment, as it is necessary to ensure the safety of our country.

But from your perspective, what is the effect of this higher level of investment in homeland security; and do you have concerns that it will lead to lower economic growth as investment flows to less-productive sectors?

Mr. GREENSPAN. Well, I would agree with the way you put the issue, Congresswoman.

Obviously, to the extent that a society devotes part of its resources for protection, those resources cannot also be used to produce goods and services or increase productivity.

We have been fortunate in this country that—I would have assumed, following 9/11/2001, that we would see some impact on pro-

ductivity as a consequence of the increased efforts that were devoted, the diversion of resources, toward protection. It did not happen that way. Indeed, as you know, our productivity actually accelerated.

But there is no question that the use of those resources are displacing resources that would otherwise be used for productive purposes, and this is one of the reasons that the Congress has to make the judgment as to: at what level do we try to insure ourselves against this sort of violence.

Ms. VELAZQUEZ. Mr. Chairman, due to the job losses in manufacturing and the sluggish hiring we are seeing in corporate America, many individuals are entering the growing ranks of the self-employed.

The most recent Labor data suggest that self-employed workers constitute a growing segment of the U.S. labor market. Many have become self-employed out of necessity, with no other option but to seek out any work they can locate on their own.

While this helps keep corporate America's expenses lean, the newly self-employed often must purchase health or retirement coverage, at great cost, or go without such benefits altogether.

If this trend were maintained, what would be the long-term economic effect of this shift toward higher self-employment?

Mr. GREENSPAN. Well, fortunately, Congresswoman, I think that the trend has changed. In other words, the very most recent data do suggest that there is an increasing return of self-employed to the corporate sector more generally.

And incidentally, one of the reasons I suspect it is probably happening is that medical costs being provided by corporate organizations are attractive to a number who are not doing as well, self-employed, as they would like.

Clearly, it is an issue here of: Do we like to have a lot of self-employed in the country? Of course we would. Do we want to have them because they lost jobs? The answer is, of course: not.

But I think the facts are that this is not becoming an ever-increasingly difficult problem, and I trust that it will continue to be that way in the future.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from the first state, Mr. Castle?

Mr. CASTLE. Thank you, Mr. Chairman.

Chairman Greenspan, I am also interested in some of the data security issues that I understand Mrs. Pryce spoke to you about. Unfortunately, I had to handle an amendment in another committee, so I have just come back and missed some of that.

But let me ask you, first and foremost, just to make sure this is clear. As you know, the various states have been dealing with this, passing legislation in a variety of ways.

Is it your judgment that this is an issue in which federal preemption is essential, at least in large part, or would you make exceptions in certain areas, versus state legislation?

Mr. GREENSPAN. I missed your point. What issue?

Mr. CASTLE. I am sorry. The data security issue and the protection of data.

Mr. GREENSPAN. Yes.

It is hard for me to answer that. In other words, the self-interests of the people who handle data, and that those data be secured, is so extraordinarily high, I just balk at the notion that anyone has to tell them what their self-interest is. I cannot believe that we need regulations to tell people how to make a profit. And in this regard, unless they protect those data, they are going to have some very serious problems.

Mr. CASTLE. Just as a matter of discussion—I agree with you, obviously, completely on that. I personally feel we do have to do something on the federal level. I do feel that you cannot have 50 different state laws on a variety of these issues.

Mr. GREENSPAN. Okay. If you are asking whether it is better to have fewer laws than a proliferation of state laws on this issue, I would say, Of course.

Mr. CASTLE. Right.

Mr. GREENSPAN. But I just hesitate to accept the overall concept that this is something which is a federal issue or government issue, in the broadest sense, to the extent that we are making it.

Mr. CASTLE. Right. I agree with you on that too, but unfortunately the media drives this to a degree. And I worry about over-notification. I worry about the fact we overreact, to a great degree, about these various things. So your concerns are legitimate.

On the other hand, it seems to me, under Gramm-Leach-Bliley, that we did a lot to address this as far as financial institutions are concerned. But then you have a heck of a lot of other people, it turns out, who are dealing with data, companies—we hear their names, we do not even know what they do—who are not under any kind of a regulator at this point, and they are into the enforcement side of it, I guess, under the FTC.

So as a result, I think that is where a lot of the breaches have been. I mean, some of the stuff is amazing to me. I mean, it is in transportation, it is in——

Mr. GREENSPAN. It is remarkable.

Mr. CASTLE.—not encrypting it at all. I mean, it is just amazing that it happens. So I think that we need to do something.

Mr. GREENSPAN. Yes. I would certainly say this, that this issue has to be resolved. I mean, it cannot fester, because I think we will have some serious consequences. It has not, really, yet, but it could.

And I do not deny that where issues of legality are involved statutes are required for clarification and understanding whose rights are in what particular area. I have heard some incredibly complex stories of people who, for example, had outsourced certain types of projects with a huge number of names which they had collected which got lost, and they are responsible.

So the question of "Who is legally responsible under those sorts of conditions?" is a critical issue which the law has to address.

I am just basically saying what I am a little concerned about, is that we all of a sudden have this major advance in technology—which is the whole electronic system—and that it is making major incursions into many areas where huge progress is occurring, and I am a little worried that we will stifle the process if we overdo it.

But if you are getting at the issue on responsibility, on who has responsibility in the event of event X——

Mr. CASTLE. Right.

Mr. GREENSPAN.—which is a legal question, then anything that clarifies that, I think, is essential.

Mr. CASTLE. Would be helpful, right.

I think there are consumer issues as well, the consumer reaction. All of us here in this room are consumers, probably, of all this, and how would we react to different notices we get. I mean, that is a whole other area that is very, very difficult, in terms of what we do, credit freezes and stopping our credit cards and that kind of thing. So I think we have to do a lot of work there.

But I appreciate your thoughts on it.

I yield back to the chairman.

The CHAIRMAN. The gentleman yields back.

The gentlelady from Oregon, Ms. Hooley?

Ms. HOOLEY. Thank you, Mr. Chairman.

Thank you, Mr. Greenspan, for appearing today.

According to a letter you wrote to the Joint Economic Committee of Congress, you said, "High energy costs are forecast to shave three-quarters of a percentage point off this year's growth to the U.S. gross domestic product." You also noted that "The U.S. economy seems to be coping pretty well with the runup of crude oil prices, aside from these headwinds."

Well, I know many middle-income families making the decision of whether or not to take a vacation this summer might disagree with you.

Rising gas costs of well over $2.50 a gallon certainly impacts a majority of family budgets. And in my state, of Oregon, we are suffering still a 6.5 percent unemployment rate, and many people would argue that impact is already being felt.

My question is: If the economy is coping well and these are only headwinds, at what point do the rising gas prices pose a serious threat to our markets and economy; and at what price level will our economy no longer be able to cope?

Mr. GREENSPAN. Well, Congresswoman, it depends not only on the level of prices but on the pace of change, and the reason I say that is, what we seem to do with gasoline consumption, and probably diesel as well, is: When prices go up, we consume just the same amount of gasoline, largely because we do not curtail our travel very much.

If you look at the aggregate amount of motor gasoline consumption in the face of this very sharp rise in price, you will be hard-pressed to find any reduction. Yet what we do know from experience is that while people do not cut their mileages down very much, they do tend, when prices go up, to buy cars and trucks with much better fuel efficiency.

And so over time, if prices stay up, what is going to happen is that the amount of gasoline consumed is going to go down, and indeed it could go down quite considerably. People will be traveling in lighter cars, more fuel-efficient, maybe more hybrids.

One thing about Americans is that our cars are critical to our day-by-day existence, and they do notice when gasoline prices go up; and it probably does curtail other forms of spending. Indeed you can see it in certain income groups, where high gasoline prices lead to less purchases elsewhere. But what they do not do is drive fewer miles. At least that is what the data suggests.

Ms. HOOLEY. I would like to take just a different tact, very shortly, and talk a little bit about the currency prices in China.

Sixty percent of China's economists think they should allow the country's currency to increase in value sometime this year.

Would you advocate a gradual increase in the value of Chinese currency; and what would be the impact on both the American and global economy; and if China refuses to increase the value of their currency significantly, would you advocate imposing punitive tariffs against China's imports?

Mr. GREENSPAN. Well, first of all, I have said previously that I believe it is in China's interest to allow its currency to move up, largely because the procedures that it uses to support its currency requires that their central bank accumulate very large quantities of U.S. Treasury securities.

Unless they sterilize that very substantial inflow, they create significant distortions in their financial system, and ultimately it could be very serious for the Chinese economy.

They know that, and they have said that they intend to adjust the currency. The issue that seems to be on the table is when, and what is the nature of the change?

I would not be in favor of a significant punitive tariff, so to speak, largely because I do not think, one, it will accomplish what a lot of people think it would—namely, significantly improve jobs and manufacturing in the United States. But also because the global system is something which is terribly important, not only to the world at large but very specifically to the United States. And anything that we do which restricts world globalization, at the end of the day, redounds to our disadvantage.

The CHAIRMAN. The gentlelady's time has expired.

Ms. HOOLEY. Thank you.

The CHAIRMAN. The gentleman from California, Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman Greenspan, it is nice to have you back before our committee, and I hope we will continue to hear from you in the future. I hope you will be a visitor in years to come.

I would like to also add that I am most appreciative of the many years of service you have given to the United States of America and the wise counsel that you have shared with us on so many occasions.

I would like to ask you a question going to a bill that the committee recently passed to strengthen oversight of the housing GSEs.

In my view, the legislation has a number of positives in it; however, I could not support it because the negatives outweigh the positives. And, unfortunately, as we considered this legislation in the committee, we did not seek the formal views of the Federal Reserve.

However, in your testimony to the Senate Banking Committee earlier this year, in April, you stated that: "To fend off possible future systemic difficulties, which we assess as likely if GSE expansion continues unabated, preventative actions are required sooner rather than later."

Before we have a full vote in the House of Representatives, I wanted to ask you if you believe H.R. 1461 is sufficient reform. Does it fully address the concerns of the Federal Reserve?

Mr. GREENSPAN. It does not, Congressman.

I think that there are several aspects of the act passed by this committee which do not address the concerns that we at the Federal Reserve have, most specifically the issue of the size of the portfolios which have been accumulated over the years by the GSEs, which concern us in ways which you just described. Unless and until we can address those issues, I do not think we have appropriately removed what is a very significant threat to our financial system longer-term.

Mr. ROYCE. Let me ask this, then. In your opinion, would no bill be better than moving the approach in 1461 at this time?

Mr. GREENSPAN. That would be my opinion.

Mr. ROYCE. Okay.

Mr. Chairman, a number of people have criticized both the Federal Reserve and the administration for moving the goal posts, as they say, on GSE reform. Essentially, the criticism is that the Fed was not talking about portfolio limits 2 years ago and now is saying, you know, that the limits are a much-needed step in the reform of oversight; and I wondered if you could explain how and why the board of governors came to this conclusion.

Mr. GREENSPAN. I think that is describing the situation quite correctly.

It is called a learning process. It has taken us a considerable period to understand the internal mechanisms of how those GSEs function, what their structure is with respect to securitization and portfolio accumulation, how they make their profits, how they are a profit-making organization, primarily, and how they try to meld that with their housing GSE goals.

It is a very complex system. I have been in the financial system for many, many decades, and when I first took a look at them, I did not understand how they worked, I mean what it is they were doing, and it took a while; and I must say that, with the help of Federal Reserve staff, we learned how they worked, and as we learned, we recognized the extent of the type of risks which they impose on the structure.

And so our changing view is merely a learning curve, and we did not understand the significance 2 years ago, for example, of what was going on.

Mr. ROYCE. Thank you very much, Chairman Greenspan.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman yields back.

The gentlelady from Indiana, Ms. Carson?

Ms. CARSON. Thank you very much, Mr. Chairman.

Thank you very much, Mr. Greenspan, for being here and for your public service, and also for the financial literacy workshop that you conducted for me. It has been very beneficial.

Mr. GREENSPAN. Thank you very much.

Ms. CARSON. Grants for downpayments, where we give money to people to buy homes, I noticed in your statement, on Page 10, you talk about the increase in the prevalence of interest-only loans and the introduction of more exotic forms of adjustable-rate mortgages.

Would you consider the giving of a grant for a downpayment for a low-income family to be an exotic form of support?

And then also I am concerned about the housing market, because I am the queen of predatory lending. And also I think Indiana still ranks highest among foreclosures. So that sort of relates to the question that I asked.

But, anyway, I know you have taken steps to control inflation, but there is still a dearth of housing available to people with modest incomes, but I am afraid that the availability is pricing the moderate-income people out of the housing market.

Thirdly, if you have time, can you comment on whether or not the oil prices that our consumers face are related to a war. It is not a political question. It is whether or not you believe that the fires in the oil fields and the drawing up of the oils has in fact got a direct correlation to the insurmountable inflation prices of oil.

Thank you very much, Mr. Chairman.

Mr. GREENSPAN. First of all, I do not consider that grants to low-income families for downpayments are a problem that is systemic to the financial system. That is not the issue that I was raising.

I was raising the questions of the use of, say, for example, interest-only mortgages; which, incidentally, properly employed are perfectly fine instruments, but not for those who need to find some new exotic form of mortgage to raise enough money to buy a house that they want to buy.

In other words, if you need an exotic mortgage—and there are all sorts of odd types of mortgages, which essentially seem to cost little now but much more later, which you employ because you want to purchase a much higher-priced house—it is those types of mortgages that I am concerned about; in other words, that the safety and soundness of banks requires that the mortgagor is able to repay the mortgage or the bank has got a problem.

And so it is that type of issue, which I think is currently being addressed by supervisors in the Federal Reserve, in the OCC, and others. The general view of this issue is not that we want to address this huge expansion in homebuilding and home prices by using supervisory capabilities, that we have, to restrain the markets.

Our judgment is basically based on making certain that there are sound loans that are being made. If that is done, it will tend to constrain excesses in the marketplace. But it is not the excesses which are essentially driving our supervisory activities as such.

With respect to the oil issue, the oil price is up largely because demand has been rising and there is a shortage of capacity, or at least perceived excess capacity. I think that that would have occurred with or without the wars.

Ms. CARSON. Thank you, Mr. Chairman.

Yield back.

The CHAIRMAN. The gentlelady yields back.

The gentlelady from New York, Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

Chairman Greenspan, thank you so much for your patience in coming to report to us, this committee.

You mentioned the London attacks in your testimony, and earlier this year we had a dialogue about the terrorism insurance area and

where you believe that government activity is needed; and you stated at the time there was not an efficient market that was functioning in the area and it really probably cannot because violence is very difficult to quantify.

I am wondering if the London attacks recently have done anything to change your view on this issue.

Mr. GREENSPAN. Well, I think this is an extraordinarily difficult question.

The issue that I have been concerned about is the difficulties that our system would have in meeting very large costs of a terrorist attack. The question is, you know: How does a civilized society, with a rule of law, deal with losses from violence? I mean, it is essentially a critical question.

We socialize part of it in the sense that we substitute military and police power for individual protection, but I think we—correctly—choose to leave the vast majority of risk to be absorbed by the private sector; and the reason for that is that, unless risk is essentially a private issue, the allocation of capital in a market economy is not optimized and that therefore standards of living are not optimized.

So what we have got is the issue here of scale. To the extent that modest historic levels of violence occur, the private market has been wholly and fully capable of dealing with that.

The type of terrorism that is arising in the context of increasing technologies which were not available before has created the possibilities of huge losses, and there is no way for a private system to handle that.

Private markets presuppose an essentially nonviolent environment where individual voluntary exchange can go on, people can deal with one another without fear. You throw a bomb in the middle of that, and people withdraw, the division of labor goes down, the GDP goes down.

It is very difficult for a free market society to deal with outsized levels of violence.

As a consequence of that, I think what the Congress has got to do is to recognize that it is a tradeoff here. That is, so long as we have terrorism which has the capability of a very substantial scope of damage, there is no way you can expect private insurance system to handle that.

But we have to be careful, in creating whatever we do in government insurance or reinsurance, to make certain that we do not go beyond the point which is necessary, because obviously everybody likes free goods, and the government can create them.

To the extent that we socialize risk, we reduce our standard of living. And so it is a tradeoff.

But as I indicated when this issue came up in the last committee meeting, I do not see how we can avoid the issue of a significant segment of government-backed reinsurance in this particular area.

Mrs. KELLY. All things being equal, Mr. Chairman, if TRIA were modified to create a government-backed reinsurer that had access to capital markets and a Treasury window for borrowing, what kind of ownership structure provides the most discipline for owners and investors in the securities?

Mr. GREENSPAN. I do not know specifically, but I do know that we are already beginning to see private solutions to a lot of the types of problems that we have got; and I think it is important to recognize that if the government decides to move in and set up a large structure immediately, it will abort those activities which are effectively addressing the system.

You know, there is another interesting question here, which is a very major question of tradeoffs: To what extent do you recognize the rise of terrorism as an element which should affect our lives? I mean, clearly it has to affect our lives, and does.

And we are confronted with the issue of how we trade off the question of trying to change our way of life to minimize the losses that occur because terrorism exists, which means it tells us where we build, how high we build, what types of trophy buildings we construct.

How much of that do we want to preserve and how much of that do we cut back on? These are very tough judgments. And in the sense—the markets will do it.

In other words, if Congress will enact a certain law, then the markets will adjust to that. It is an issue which is not going to be readily and easily resolved. Civilized societies have not had to deal with this type of technology of terrorism previously.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from California, Mr. Sherman?

Mr. SHERMAN. Thank you, Mr. Chairman.

I ask unanimous consent that we all be given 5 days to submit additional questions for the record.

The CHAIRMAN. Without objection.

Mr. SHERMAN. Mr. Chairman of the Federal Reserve Board, so many have bemoaned the fact that this is your last appearance before us. I think they should be seeking solutions to this.

First, I hope you will come back and share your wisdom with us, even if you are no longer drawing a government paycheck.

But I will be introducing legislation to say that someone who has served a part of a term and then served a full 14-year term can still be appointed for another 5 years to the Federal Reserve, and I know my colleagues would begin chanting "5 more years" except they do not want to erode my 5 more minutes.

Mr. GREENSPAN. Does my wife have a vote in this?

[Laughter.]

Mr. SHERMAN. Thank God she does not.

I have got so many questions I will basically be submitting them for the record.

We are heading eventually for a realignment of currency values such that our trade deficit is ameliorated, perhaps reversed. It is deferrable. But this realignment is not avoidable. It will have benefits. It will also have enormous harms, even if it is done smoothly. But if it is not smoothly, it could be a disaster.

I will be asking in writing how we can work with other countries to assure that there is a smooth currency realignment and not a crash of the dollar.

I will be submitting questions about the importance of subprime lending to our economy, particularly when those loans are not made by depository institutions that are insured by the federal gov-

ernment but do not pose those risks because they are made by private uninsured lenders; andd I will also be asking about the importance of the private auditing function to our capital markets.

A recent op-ed in the American Banker notes that our committee and the House passed this—well, our committee passed this GSE reform bill, and we reported it out by an overwhelming vote, that it would establish a better regulator for the GSEs; and I will be asking whether you would concur in this assessment or whether you would agree that stronger capital and prompt corrective action authority as provided in the bill makes sense and just how important it is that Congress pass GSE reform legislation this year.

One issue I have asked you about before is the issue of the regulations issued by the Treasury Department and the Federal Reserve Board allowing national banks to engage in real estate brokerage and real estate management.

As you know, these regulations have been blocked by congressional action on an annual basis, which is hardly an efficient way to provide for a national system to regulate who can and cannot, and under what circumstances, engage in real estate brokerage activity.

Now, you have consistently opposed mixing banking and commerce, and a commercial activity is a commercial activity even if it involves financing.

For many of my working-class-family constituents, they are not even aspiring to buy a home, they are aspiring to buy a car, and the lending function who will make the loan is the most important part of selecting an automobile dealer. Wheat and steel, even this shirt, can be financed on a credit card, so just because something is financed does not mean it is not commerce.

So I hope you would explain: Why is buying and selling of real estate a financial activity if buying and selling cars, steel, et cetera, is not?

Perhaps you could respond orally to that question.

Mr. GREENSPAN. You want me to respond——

Mr. SHERMAN. Yes. I actually think I have some time.

Mr. GREENSPAN. Yes.

Let me just say that the broader question, which is finance and commerce, is one which will gradually erode in the sense that technology is making the distinction ever less obvious.

Our general concern is not that mixing banking and commerce is inherently dangerous; it is that we do not wish to see it occur too quickly, because we are currently in the process, at this stage, of absorbing very significant changes in technology, globalization, structures in finance, and we have seen very major changes in the financial system.

And it is very important, from the supervisory point of view, to be able to judge what is occurring; and, so far, we conceive of the way we, as umbrella supervisors of various institutions, have been able to interrelate with an evolving, fairly rapid, change in technology.

If we were to break the bounds of banking and commerce at this stage, we would get some very discontinuous changes, which, we are fearful, would make it exceptionally difficult to supervise according to the statutes that we operate under.

So it is not that we are saying that there is something fundamentally different about these activities, because they are not. I mean, finance gradually looks like commerce and commerce looks like——

Mr. SHERMAN. If I can interject——

The CHAIRMAN. The gentleman's time has expired.

Mr. SHERMAN. I would just say "5 more years."

Thank you.

Mr. PAUL. Thank you, Mr. Chairman.

If indeed this is your last appearance before our committee, Mr. Greenspan, I would have to say that in the future I am sure I will find these hearings a lot less interesting.

[Laughter.]

But I do have a couple of parting questions for you.

Keynes, when he wrote his general theory, made the point that he had a tremendous faith in central bank credit creation because it would stimulate productivity. But along with this, he also recognized that it would push prices and labor costs up. He saw this as a convenience, not a disadvantage, because he realized that in the corrective phase of the economic business cycle, that wages had to go down, and people would not accept a nominal decrease in wages; but if they were decreased in real terms, it would serve the economic benefit.

Likewise, I think this same principle can be applied to our debt. To me, this system that we have today is a convenient way to default on our debt, to liquidate debt through the inflationary scheme.

Even you, in the 1960s, described the paper system as a scheme for the confiscation of wealth. And in many ways I think this is exactly what has happened. We have learned to adapt to deficit financing, but in many ways the total debt is not that bad because it goes down in real terms. As bad as it is, in real terms it is not nearly as high.

But since we went on a total paper standard in 1971, we have increased our money supply essentially 12-fold. Debt in this country, federal debt, has gone up 19-fold; but that is in nominal dollars, not in real dollars.

So my question is this: Is it not true that the paper system that we work with today is actually a scheme to default on our debt? And is it not true that, for this reason, that is a good argument for people not—eventually, at some day—wanting to buy Treasury bills because they will be paid back with cheaper dollars?

And indeed in our lifetime we certainly experienced this in the late 1970s, that interest rates had to go up pretty high, and that this paper system serves the interests of big government and deficit financing because it is a sneaky way of paying for deficit financing. At the same time, it hurts the people who are retired and put their money in savings.

And aligned with this question, I would like to ask something dealing exactly with gold: If paper money—today it seems to be working rather well, but if the paper system does not work, when will the time come, what will the signs be, that we should reconsider gold?

Even in 1981, when you came before the Gold Commission, people were frightened about what was happening, and that was not too many years ago, and you testified that it might not be a bad idea to back our government bonds with gold in order to bring down interest rates.

So what are the conditions that might exist for the central bankers of the world to reconsider gold? We do know that they have not given up on gold. They have not gotten rid of their gold. They are holding it there for some reason.

So what is the purpose of the gold if it is not with the idea that someday they might need it? They do not hold lead or pork bellies; they hold gold.

So what are the conditions that you might anticipate when the world may reconsider gold?

Mr. GREENSPAN. Well, you say central banks own gold or monetary authorities own gold. The United States is a large gold holder. And you have to ask yourself: Why do we hold gold? And the answer is essentially implicitly the one that you have raise; namely, that over the generations, when fiat monies arose, and indeed created the type of problems, which I think you correctly identify, for the 1970s, although the implication that it was some scheme or conspiracy gives it a much more conscious focus than actually, as I recall it, was occurring, it was more inadvertence that created the basic problems.

But as I have testified here before to a similar question, central bankers began to realize in the late 1970s how deleterious a factor the inflation was, and indeed since the late 1970s central bankers generally have behaved as though we were on the gold standard.

And indeed the extent of liquidity contraction that has occurred as a consequence of the various different efforts on the part of monetary authorities is a clear indication that we recognize that excessive creation of liquidity creates inflation, which in turn undermines economic growth.

So that the question is: Would there be any advantage, at this particular stage, in going back to the gold standard? And the answer is: I do not think so, because we are acting as though we were there.

Would it have been a question, at least open, in 1981, as you put it? And the answer was: Yes. Remember, the gold price was $800 an ounce. We were dealing with extraordinary imbalances; interest rates were up sharply; the system looked to be highly unstable; and we needed to do something. Now, we did something.

In the United States, Paul Volcker, as you may recall, in 1979 came into office and put a very severe clamp on the expansion of credit, and that led to a long sequence of events here, which we are benefiting from up to this date.

So central banking, I believe, has learned the dangers of fiat money, and I think as a consequence of that we have behaved as though there are indeed real reserves underneath the system.

Mrs. KELLY. [Presiding.] The gentleman's time has expired.

Ms. Lee?

Ms. LEE. Thank you, Madam Chair.

Hello, Mr. Greenspan. Good to see you again.

Let me also thank you for your years of dedicated service. And I just want to also thank you for your very forthright interaction with many of our organizations around the country, especially in California, such as the Greenlining Institute, and I think that——

Mr. GREENSPAN. They are good friends.

Ms. LEE. And thank you very much for everything that you have done to help move this agenda forward, in terms of the fairness in our economic system.

I wanted to ask you a couple of things. And we have been in touch with each other over the years with regard to CRA, and I want to thank you—the Community Reinvestment Act, and why and how banks can receive an A rating when in fact they are lending to African-Americans and Latinos, in terms of home lending, between 2 and 3 percent. As it relates to the Hispanic community in California, I think it is about 18 percent, when 35 percent of the population is Latino.

And your response, of course, was that CRA cannot, you know, deal with the ethnic composition of any lending transaction because they are not required to, but the enforcement of fair lending laws is what would allow for the insurance of nondiscrimination actions.

But yet I have to ask you: The fair lending laws appear not to have been enforced, given the very dismal mortgage lending rates of these institutions. And so in going back and forth, over the years, I have been reading your responses, and I want to ask you today if it makes sense, then, that we ask you to look at how to conduct—or maybe the Federal Reserve could conduct—a disparity study, to really begin to look at what is taking place, because, for the life of me, I cannot understand why in fact the home lending rate is so low when in fact these institutions are getting such high ratings.

And so I would like to ask for some specific solutions to this so that we can move forward to ensure more fairness in mortgage lending.

Mr. GREENSPAN. Yes, this is a very difficult issue, which, of course, we have all been struggling with for quite a good deal of time.

We, at the Federal Reserve—and indeed this is also true at our colleagues at the other banking regulatory agencies—enforce a statute which is passed by the Congress. We do it as best we can and indeed endeavor not only to capture the letter of the law but the spirit of the law as well. We cannot go beyond that. In other words, we do not create the laws.

Ms. LEE. But, Mr. Greenspan, Mr. Chairman, let me just ask you, though: Should not we consider at this point an amendment, maybe, to the Community Reinvestment Act, to broaden, for example, the goal to at least gather this data so we will know?

Mr. GREENSPAN. Well, I think there is an issue here which has to do with what type of data and what type of burdens you put on institutions in collecting the data, because it is not a costless operation.

Ms. LEE. Sure.

Mr. GREENSPAN. I do think we, for example, have expanded HMDA over the years—I mean, we will be releasing HMDA data,

I believe, in a couple of months for the year 2004—and there are many new sources of information in those data systems.

And in that regard, it is a very large data requirement that is involved here, and there are obviously going to be continuing discussions of what types of information, what types of evidence of discrimination occurs, and how does one essentially pick it up. But it is not a simple solution.

Ms. LEE. I understand, Mr. Greenspan.

Before my time is up, let me just say I understand the fact that this would cost some money. But I think, long-term, the cost of discrimination and the costs of denying loans to minority potential homeowners far exceed the cost of gathering the data.

When you look at small business lending, it is my understanding now—and we are looking to verify this information—that African-American-owned businesses receive less than 2 percent of the small business lending; Latino-owned businesses less than 2 percent also.

And so at some point, in addition to trying to enforce fair lending laws, we have got to do something to make sure that there does not exist discrimination and that there is a level playing field in the future whether it costs the financial services industry a few dollars or not.

Mr. GREENSPAN. Well, I agree with——

Mrs. KELLY. The gentlewoman's time has expired.

Ms. LEE. I will follow up with you——

Mr. GREENSPAN. I agree with what you stated.

The issue basically is, how do we extricate the discriminatory forces which inevitably still exist in the system? It is an ongoing project, and I think we are making progress, but I certainly agree that there is more to be done.

Ms. LEE. Thank you, Mr. Chairman.

Mrs. KELLY. Mr. Gillmor?

Mr. GILLMOR. Thank you, Madam Chairwoman.

Mr. Greenspan, I want to commend you for the great job you have done over the years, and for your service to the country. You are going to be missed.

I have a couple of questions regarding ILCs, industrial loan companies, I would like your views on.

Could you give us your thoughts about the rapid expansion of commercial firms obtaining industrial loan company charters and what that means for the overall banking system? And in respect to that, are there any risks, or even systemic risk, to our banking system in the avoidance of Fed oversight that an ILC charter allows?

Mr. GREENSPAN. This issue is related to the issue we discussed just a short while ago with respect to the question of the move from banking to commerce that is really an issue here.

The ILC is, as you point out, not subject to umbrella supervision, as indeed other banking institutions are; and there is a concern on our part that an expansion in this particular area—especially if they are given additional powers, which create essentially commercial banks—that we have effectively made a decision to eliminate the distinction between banking and commerce, inadvertently; in other words, by basically creating an ILC which ultimately turns out to be a commercial bank which can be owned by a commercial interest.

If that is indeed the case, Congress ought to do it directly. My reaction, however, is that if we do it—and we will eventually do it—it be done in a way which is measured and understood to be sufficiently sensitive to the supervisory adjustments that go along with that process.

So I think that what our major concern is, is not, as I said before, the issue of breaching commerce and banking over the long run—which we think is probably inevitable and is something that can and should be handled—it is the way we are doing it. I think that is wrong.

Mr. GILLMOR. Well, you indicate it might or might not be inevitable. If I am reading your response fairly, I think you are saying it is not a good idea. Would that be accurate?

Mr. GREENSPAN. Yes: It is not a good idea. I am sorry if I did not make that clearer.

Mr. GILLMOR. Well, you probably did, but I just wanted to drive a nail through the board.

Let me ask you another question—and maybe it has come up before, but I had to be in another markup.

House prices are up, obviously, a great deal, so for people to afford them you have got the use of ARMS, you have got no downpayment, you have got interest-only loans. It seems to me that a lot of people are kind of cutting it very thin financially.

And so I guess my question is: If we do have a spike in long-term rates, sooner or later there are going to have to be payments on those no-interest loans; the adjustable-rate mortgages are going to go up.

In your view, what would be the impact of a significant spike in rates on the people who have gotten into the housing market in that manner?

Mr. GREENSPAN. Well, incidentally, one of the reasons why we have engaged in the type of monetary policy which we have over the past year is to reduce the probability of that occurring. And obviously, should that occur, we will have, obviously, adjustable-rate mortgages will be impacted.

However, remember that most recent adjustable-rate mortgages, to a very large extent, begin with a fixed component. In other words, they are not immediately variable. So the actual level of mortgage debt which is interest-sensitive at this particular stage, including what we call adjustable-rate mortgages, is not very high.

But it is certainly the case that, over time, if you get a spike in interest rates—and indeed by a spike I assume you mean they go up and they stay there—then their effects are quite significant.

And I must say: It is basically a function of appropriate monetary policy to avoid such outcomes.

Mr. GILLMOR. Thank you, Mr. Chairman.

Mrs. KELLY. Thank you.

Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you.

Mr. Chairman, last July you testified before this committee that average hourly earnings of non-supervisory workers had been subdued in recent months and barely budged in June.

I cannot find any reference in your testimony today to average hourly earnings with non-supervisory workers. Mr. Frank pointed

to the information in your report about earnings, or wages, but it does not seem to match that figure.

It does say that the employment cost index for hourly compensation had actually gone down about half a percentage point from what it had been the last couple of years.

On the continuum from subdued to modest to exuberant to frothy, where do increases in average hourly earnings of non-supervisory workers fall?

Mr. GREENSPAN. Well, I think what we do, basically, is we collect data from various different sources. The broadest coverage of wages and salaries in this country is the quarterly report that occurs as a consequence of companies reporting for unemployment insurance coverage, which is universal; and those numbers are probably coverage way up into the high 90s, and they are fairly complete.

We have another set of data which essentially endeavors to pick up production workers as distinct from supervisory workers, and that is about 80 percent of the workforce.

So we separate the wages and salaries into the production workers and into supervisory workers, essentially, the 20 percent, or the skilled management professional.

What we find is the production workers' average hourly earnings are rising very modestly; but because of the distribution of skilled worker supply and demand, we are finding that the increase implicitly in supervisory workers' average hourly earnings is going up very much more rapidly.

Mr. MILLER OF NORTH CAROLINA. I am sorry, say that again.

Mr. GREENSPAN. It is going up very much more rapidly——

Mr. MILLER OF NORTH CAROLINA. For the supervisory employees?

Mr. GREENSPAN.—for the supervisory workers, the 20 percent; the supervisory, professional, et cetera, the more skilled aspects of our labor force.

So we are getting a bivariate income distribution. And as I have said many times in the past: For a democratic society, this is not healthful, to say the least; and as I have indicated on numerous occasions, I believe this is an education problem that requires us to get the balance of skills coming out of our schools to match the skills that our physical facilities require.

So there is a reconciliation, and the reconciliation is that we are getting some really divergent trends.

Mr. MILLER OF NORTH CAROLINA. Mr. Greenspan, Mr. Chairman, you did testify about home mortgages and about the concerns about exotic mortgages and said that home equity extraction was occurring, mortgage market finance withdrawals of home equity—in other words, people were borrowing against their homes—and it seems to be that homeownership, as Chairman Oxley said, is good news, but it is about the only good news in the American economy for most workers—about 80 percent—whose wages remain subdued or increasing modestly.

All of your testimony appears to go to the effect this is having on the safety and soundness of lenders or on the effect on housing prices.

Have you looked at what these exotic mortgages, particularly for refinancing, are doing to the economic status of most American families?

You pointed out we have a 1 percent savings rate. The latest figure I have seen on credit card debt is $800 billion. Wages for 80 percent of American workers are very modest or subdued, and their increase—and the good news that 69 percent of American families own their homes but the equity in their homes is the bulk of their net worth.

What are these exotic mortgages for refinancing doing to the financial position of American families?

Mr. GREENSPAN. Well, fortunately, Congressman, not much yet, because they are still very small. In other words, it is the tip of an iceberg, that we are concerned about that it gets larger.

In the total scheme of things, the aggregate amounts are small. But for individual cases, they could be disastrous, largely because there are a number of loans which require, for example, no equity early on; and if you have gotten your downpayment through a piggyback loan or something like that, you are essentially depending on the price of the home continuing to rise and your equity continuing to rise—and that is a little bit tricky, because this type of expansion in prices historically does not go on very long.

And indeed, while it is hard to forecast—and I am not sure that it is going to occur—there may be, and certainly will be, in certain local areas, price declines; and if you have some of these interest-only, very low downpayment, exotic mortgages, which essentially are issued by banking or other institutions on the expectation that prices will continue to go up and therefore the loan will always be good, if you are depending on that, there is potential individual disaster there.

Fortunately, that is a very select and small group so far, and we very much would like to keep it that way.

Mrs. KELLY. The gentleman's time has expired.

Mr. Shays?

Mr. SHAYS. Thank you, Chairman Greenspan.

I think that you, frankly, are one of the most important powerful individuals in the world and one of the most outstanding public servants, and I thank you for using your power well and for being such an outstanding public servant.

I have a number of questions, and if the answers could be as brief as possible, I might get to a few.

I look at the budget deficits, the trade deficits, the unfunded liability that the federal government has in Social Security and Medicare, I look at state budget deficits and their debt and their liabilities and pension funds and so on, and it seems pretty significant to me.

And then I look at the low level of savings that Americans have, and I am wondering why—I am amazed that the economy does so well in spite of that. I would like the short version of why it does so well in spite of that.

Mr. GREENSPAN. First of all, even though we have a very low level of savings, we use our savings exceptionally efficiently, and by that I mean we have a really quite sophisticated financial system which enables us to use the little savings that we have most productively, and that shows up in the increased productivity that we are able to function with.

But the other issues that you present are long-term problems, and it is hard to imagine how we can continue on without addressing those issues.

Mr. SHAYS. Yes.

I am surprised that it costs me $55 to put gasoline in my Jeep, that these incredibly significant increases in oil prices has not brought down our economies, and I do not understand why.

Mr. GREENSPAN. Well, to a very large extent, it is the fact that following the oil shocks of the 1970s, there was a very dramatic decline in the intensity of the use of oil. In other words, oil in barrels divided by real GDP has been going down at a very dramatic pace. And indeed, it is only half of what it was 30 years ago, and it is still going down. And the basic reason, the answer, is that everybody is adjusting to the fact that oil prices are high.

Mr. SHAYS. I hear that.

But it seems to me that it has been such a—I mean, a dollar increase in prices per gallon would strike me as being a pretty big shock in spite of your point about the GNP.

Mr. GREENSPAN. No, it is a shock. And indeed, as has been mentioned before, we do estimate a three-quarters of a percentage point loss in real growth this year as a consequence of these prices.

Mr. SHAYS. When I look at the housing market—first, let me ask you this.

With the decline in manufacturing jobs, is it not true that we have actually increased the productivity—not productivity, but actually increased output in manufacturing?

Mr. GREENSPAN. Output as a ratio to GDP has gone down very gradually, and indeed the reason for that, that it is going down, is that we are an increasingly conceptual economy, that an ever-increasing proportion of what we create, values that others, other countries want, are non-material.

And therefore we are seeing some gradual decline in goods production as a ratio to overall GDP, but the rest of the GDP being ideas.

Mr. SHAYS. And that is a very important point for me to think about.

But forget the ratio. Has not our output in manufacturing actually gone up?

Mr. GREENSPAN. It has, yes.

Mr. SHAYS. And so I see the same analogy when I look at agriculture. We have 3 percent in the marketplace now, whereas we used to have two-thirds in the early 1900s, but our production, you know, vastly increased.

Is it wrong for me to think that that is a bit of a comfort, or should I be concerned about the lack of even greater growth in manufacturing?

Mr. GREENSPAN. Well, I think the critical issue is that we produce something which would be accepted as value in trade by others. What it is we produce is less important, or how we do it.

And what the United States has adjusted to over the generations is to somehow maintain our leadership in the world largely by producing most efficiently those goods which consumers, our own and others, perceived as most valuable.

Mr. SHAYS. Thank you, Mr. Chairman.

Thank you, Madam Chairman.

Mrs. KELLY. Thank you.

Mr. Scott?

Mr. SCOTT. Thank you very much.

Mr. Chairman, Chairman Greenspan, so good to have you again.

And let me just also include with the chorus of praises that you rightfully deserve: We hate to see you go; and I am sure if your wife would give you the permission to stay another 5 years, we would all agree with that.

Mr. GREENSPAN. Thank you.

Mr. SCOTT. Your intellect is just extraordinary, and your contributions have been monumental. You are indeed one of the most powerful voices in the world.

And I want to get to a series of questions, that I might, and if you could be brief with your responses.

My first one is on the war on terror and our financial security here at home and around the world.

The recent bombings in London produced some extraordinary new facts in this war, one of which is that these were basically homegrown young terrorists that were citizens of Great Britain.

I am sure that Prime Minister Blair would say he went to Iraq to fight them there—as Mr. Bush has said—before they got home, but they are right there. That is a new phenomenon, that certainly raises our own concerns here at home—the homegrown cells.

The second one is that there appears to be a very, very violent and radical interpretation of the Islamic religion, that is creating tremendous problems.

I am concerned that the leaders of the Muslim world, leaders of the Muslim financial world, the Muslim world itself, is not taking its leadership and responsibility.

There seems to be no way we are going to win this war on terror, solve this terror problem—and with these new revelations coming out of the London bombing—without intense and serious and courageous leadership from the Muslim community.

Do you see that forthcoming in the Muslim world? Is there leadership coming forward in financial markets that are controlled by Muslim countries to deal with this terrorism?

It is not just a problem of the West. And with the religious factor coming into this, it is paramount, because one of the by-products could be extraordinary retaliation against the Muslim community, as we have seen in the numerous attacks in London and elsewhere, of Muslim communities.

It is important that they step forward. And I wanted to know, do you see that?

Mr. GREENSPAN. Well, I certainly see much the same things that you do, Congressman.

I do think that many people of the Islamic faith whom I deal with in the international area are acutely aware of the importance of maintaining civil societies and they are not supporters of some of the interpretations, but I am not sufficiently knowledgeable about a number of the various areas that are involved here, to give a reasonable judgment as to where we all go from here.

But I do think that issue of civility is critical to the growth of market economies, and I find that there is exactly the same view,

that those who are in Islamic countries, who are in central banking, in areas of finance, in areas of economics, are all most concerned about the issue of what they are—I think appropriately—concerned about: backlashes against people of this Islamic faith in this country and elsewhere.

Mr. SCOTT. Yes. One of the issues is in terms of terrorist financing, that emanates and weaves its way through Muslim communities, Muslim financial institutions: Are you familiar with such an endeavor that is known as "wahalas," which have been known to be suspect—from our intelligence—of being ways and means in which terrorist financing has come through legitimate Muslim financial institutions? Are you aware——

Mrs. KELLY. The gentleman's time has expired.

Mr. SCOTT. Would you respond to that?

Mr. GREENSPAN. Yes. Well, let me just say very quickly that they are a very effective and historic means of finance, and I think it is based on trust. And so to the extent that they are misused for purposes other than they were originally created for is most unfortunate, but we do, as you I am sure are well aware, have directed considerable amount of efforts at trying to identify sources of finance that will support terrorist organizations.

Obviously the U.S. Treasury Department is very acutely involved, and clearly we are aware of what, essentially, they are employed in doing.

Mr. SCOTT. Thank you.

Mrs. KELLY. Mr. Hensarling?

Mr. HENSARLING. Thank you, Madam Chair.

Chairman Greenspan, I do not know if you feel like you are being eulogized this morning, but please allow me to add my voice to those thanking you for your service to your country. It has truly been a significant and positive impact on our nation's history.

Mr. Chairman, I have seen a report from CBO, dated January of 2005, that says that Medicare over the next 10 years will grow by 9 percent, Medicaid by 7.8 percent, and Social Security by 5.6 percent a year.

I have also seen a GAO report, dated early March, entitled, "Budget Process: Long-Term Focus Is Critical." It states that as of today, if we do nothing, that we are on a collision course to either double taxes or cut federal spending by 50 percent by the year 2040.

Many of us may not be here in 2040, but we certainly hope and pray our children and grandchildren may be.

There are many in this body who have shown no inclination for handling or dealing with the spending side of the equation. You testified before the House Budget Committee on March 2nd of this year, and you said, "Tax increases of sufficient dimension to deal with our looming fiscal problems arguably pose significant risk to the economic growth and the revenue base."

So I have a two-part question. If you were familiar with the GAO and CBO reports that I allude to, do you agree with their numbers? If you do not agree with their numbers, do they get the essential thrust and trend lines correct?

And if so, what does the world look like in 2040 if we double taxes on the American people? What does that mean to housing?

What does it mean to job creation? What does it mean to standard of living?

Mr. GREENSPAN. A lot, Congressman.

Let me direct you to a footnote in my prepared remarks, in which I endeavor, essentially in short form, to address the instabilities that conceivably could occur as a consequence of the fact that we have in law already committed the allocation of resources implicitly, in real terms—which, in my judgment, may very well be in excess of what we have the capacity to deliver—and it is terribly important for us, essentially for the retirees that will begin to retire in the next decade, to make sure that they know that what they are being promised will be delivered.

I am not sure we have the capacity to do that, and this is indeed what the issue is. And CBO and GAO studies clearly come up with the same results.

Mr. HENSARLING. In an attempt to deal with at least one facet of our long-term structural deficit, a number of members of Congress, including myself, have introduced budget process reform legislation.

Many in this body hold PAYGO to be a panacea in that quest to deal with our long-term fiscal challenges, but as of today I believe that mandatory spending and interest accounts for 61 percent of the federal budget.

According to the House Budget Committee, within a decade we will go from 61 percent of the budget to mandatory and interest, to 71 percent.

I have personally introduced legislation that would include a ceiling on the growth of the federal budget. If spending is a significant part of the challenge, inasmuch as every PAYGO proposal I have seen does not deal with mandatory spending, does not deal with the automatic inflation included in baseline budgeting, and if our quest is to control spending, is not a ceiling on the growth of government a superior alternative to traditional PAYGO?

Mr. GREENSPAN. I think that there are numbers of ways you can address the question. For example, I have often advocated that all statutes be sunsetted, and that includes the Federal Reserve Act.

The importance of that is: If you get into a situation where your entitlements or mandatory spending is moving out of line, you just merely cannot say, "Well, we will pass a law and require it to come down a certain amount," because the Congress may not vote that law. In other words, what you basically need is a vehicle which will enable individual acts to be reevaluated, and indeed to get a majority, positive majority, to keep them going forward.

I am not sure that even—I have often advocated triggers and various other vehicles which address this particular type of question.

But it is a very serious issue.

Mr. HENSARLING. Well, and I certainly agree with you that sunsetting would be a very important part of the mix in the legislation.

In the time I have remaining, allow me to switch subjects, back to an earlier subject of the recent GSE legislation.

Part of that legislation includes an Affordable Housing Fund, which I believe you are acquainted with, has Fannie and Freddie

using 5 percent of their after-tax profits to fund this particular fund, on top of approximately 82 other government housing programs, all ostensibly aimed at affordable housing.

Given the duopoly nature of Fannie and Freddie, do you believe they have sufficient market power to essentially impose that cost upon the market, so that at the end of the day, perhaps, we are taking money out of one affordable housing dynamic and simply turning around and turning it over to another? Do they have sufficient power to impose that cost on the ultimate consumer?

Mr. GREENSPAN. I do not know. And indeed, all I can say to you is that we at the Federal Reserve have not taken a position on this.

It is interesting, I think, that the new CEO of Freddie Mac, Richard Syron—as I remember reading somewhere recently—claimed that there is no longer a duopoly, that they no longer have the power they used to have.

Mr. HENSARLING. Thank you, Mr. Chairman.

My time has expired.

Mrs. KELLY. Thank you.

Mr. Davis?

Mr. DAVIS OF ALABAMA. Thank you, Madam Chairwoman.

Chairman Greenspan, I certainly—like, I think, every one of my colleagues today—wish you enormously well and a lot of good fortune in the remaining part of your career and your life.

For those of us new members who have been here, like Mr. Hensarling and myself, you have been a living seminar on economic policy, and we appreciate your playing that role.

Mr. GREENSPAN. Thank you.

Mr. DAVIS OF ALABAMA. I want to ask you about the phenomenon of globalization, because one of the things that strikes me is that when you have talked about it and when a lot of people in this room have talked about, it has been in terms of an either-or kind of dynamic.

You have had people on the left, if you will, or even the extreme right, who have taken the position that globalization is counterproductive, is unfortunate; and you have taken the opposition position, I think the responsible position, that globalization is a good thing, that redounds in our favor.

But it strikes me that, frankly, for those of us who were voting on these agreements, it is not an either-or proposition in terms of globalization or nonglobalization. There is a third place, and that third place is the kind of pro-trade policies we are going to have.

It strikes me that there are two kinds of pro-trade policies that one could have. One kind would spur other countries toward reform. One kind would spur other countries to allow the right to organize or to adopt a regimen or regime that prevented child labor or to take discrimination against women more seriously.

And, frankly, another kind of pro-trade policy essentially leaves these governments and these countries as they are.

I have not heard you talk a lot about that kind of distinction.

So I want you for just a moment—and I will have another question; I will ask you to respond to them both, one after the other.

But I would like you for a moment to talk about whether or not it would be somehow detrimental to our economy and detrimental to the concept of globalization if we had included conditions in

some of these agreements that would deal with the absence of child labor laws, that would deal with the absence of sex discrimination laws, or would deal with the right to organize. Question number one.

Second set of questions has to do with the phenomenon of tax cutting. It, too, has been advanced in terms of an either-or dynamic: people on my side of this room, who say the tax cuts have been too big, they have been too outsized; you, and people on the other side of the room, have said that, "Well, the tax cuts have been good; they have been the right size to provide stimulus to our economy."

I am wondering again if there is not a third approach: if we could not have had a series of tax cuts that were distributed and aimed more toward the middle class, more toward the people whose wages have been stagnant the last several years, and I am wondering if we could have cut taxes much more dramatically for the middle class if we could have provided more tax relief for those Americans who are struggling day in and day out without imperiling the stimulative impact of the tax cuts as a whole.

So can you comment on those two sets of questions?

Mr. GREENSPAN. There is another aspect to this; namely, that you have to decide whether or not the purposes of tax cuts relate to the issue of the distribution of income or its production, and my focus has been on production.

In other words, I have been focusing on how to establish a tax structure which increases level of economic growth, and therefore a tax base, and hence revenue.

I have not been particularly focused on the question of the distribution of tax for the purpose of redistributing income, because that is basically a function of the Congress, and I have no real view on that as such.

And that is the reason, I might say, that I supported the issue of elimination of double taxation of dividends, as I have for many years, because I think that is a critical element in a tax structure which enables growth to be at its maximum.

With respect to the first issue, with respect to applying our standards to others——

Mr. DAVIS OF ALABAMA. Well, not even our standards, but just standards that are different and would raise the——

Mr. GREENSPAN. Oh, okay. No, I take the correction.

There is a cost in that. In other words, in a more general sense, are there people with whom we feel, for moral reasons, we should not trade? In other words, it is a more fundamental question about: What are the conditions which are necessary, voluntary, people or countries, to engage in trade?

And it raises a fascinating question of: Is associating with a certain group of people considered sufficiently morally offensive to your own values that you do not want to do it?

The issue of imposing standards—not ours necessarily, but some standards—is a version of that.

It is a very difficult question. There is no doubt that if you do it, you will have less trade; but that may be what you want. And it is a judgment that implicitly the Congress, again, makes.

In other words, the one thing that I have learned over the years, especially being here 35 times, is that it is you who have to answer all of these extraordinary questions and decide what do you do when confronted with choice. And my only criticism would be that sometimes—like everybody else, ourselves included—when confronted with a choice, you would prefer somebody else to do it.

But fortunately our system is such that we have to make these choices, and they are not easy. And the one that you raise, I think, is a very legitimate question, as to where your tradeoff is, basically, in that respect.

Mrs. KELLY. The gentleman's time has expired.

Mr. Pearce?

Mr. PEARCE. Thank you, Mr. Chairman.

The problem with coming this late in the day, all the adjectives have been used and the questions have been asked, so I have had to resort to extreme measures.

Mr. Shays finally did the last deal in declaring you powerful and outstanding, that took the last two words I could have used; so just let me add my voice to those of your admirers who find you also to be a handsome man.

[Laughter.]

Mr. GREENSPAN. Thank you.

Mr. PEARCE. As far as my questions, I think that you have the concern I do about—you put it much better than I do—an overabundance of highly-skilled jobs and an underabundance of highly-skilled workers.

I saw that play out when my father retired from a major oil company, and he was able to wring out, say, 100 barrels a day from certain wells, that the guy who was my age, that went on, could only get 50 barrels a day. And so we have incrementally seen a weakness in our economy because of an underperformance. And the next guy was paid exactly the same as my father was, and even more, and yet the productivity was not there.

And so I am concerned about that. But I will tell you the concern that I have, that I do not hear many people speak of, is: If we take some of the tendencies to competition, say the ILCs, or large institutions buying the smaller ones, I wonder how long our economy can go without the reinvestment in the rural parts of the country, because always capital is going to find the larger rates of return, and I will guarantee you that every rate of return on any project in Manhattan is going to quadruple or be 50 times' the most attractive project in the state of New Mexico.

And so incrementally I see our economy consolidating into the large centers, and it looks good on paper but has an underlying strength.

Would you care to comment on my concern, both a parochial concern, but then for the country overall. Can we support the nation's economy from just the large power centers?

Mr. GREENSPAN. Yes. Congressman, I am not sure I agree with you, and let me tell you why. What we do know is that the cutting edge of this economy is basically new companies which start from scratch, small business. Most of them fail. Those that really make it, do well.

Now, it may very well be the case that after they make it, the entrepreneurs move to the big city. That may be true. But the real growth in this country is in the peripheral areas, where technology and innovation is the most pronounced.

We do have an extraordinary advance that has occurred in the financial system in the United States in the last decade, which essentially has meant that we have carried technologies that would develop not in Manhattan Island, but they are most obviously applied to Manhattan, so that the value added, in a good part of Manhattan, is quite significant and growing, but the source of it is not fundamentally there.

And I think what is so extraordinary about this country is the flexibility and the mobility. People move all the time. I mean, I think something like 20 percent of our households move every year.

Mr. PEARCE. Let me address one piece of that, then, and I know we are trying to——

Mrs. KELLY. Mr. Pearce, we have been called——

Mr. PEARCE. Yes.

Mrs. KELLY.—for a vote.

Mr. PEARCE. All right. Thank you.

Mrs. KELLY. I am sorry. I am going to try to get as many people in as possible.

Mr. PEARCE. Thank you, Madam Chair.

Mrs. KELLY. Let me go now to Ms. Wasserman Schultz.

And please, Ms. Wasserman Schultz, do not take more than 2 minutes. I am going to try to get everybody in.

Ms. WASSERMAN SCHULTZ. No problem.

Thank you, Madam Chair.

Mr. Greenspan, I just wanted to ask you to touch on health care. Yesterday the Financial Times reported that U.S. companies can expect about an 11 percent increase in health care costs over the next year.

That will affect wage growth, it will affect their ability to hire more permanent workers and ask workers to share more of the expense.

Can you talk about the ever-rising effect on our economy, with the significant increase in costs for health care over the years.

Mr. GREENSPAN. This is clearly a major issue in this country. As you know, per capita we spend considerably more on health care than anybody else in the rest of the world. We do so because we have extraordinary advances in technology, and we have a much more sophisticated—overall—medical system. But we do not seem, as a consequence, to be able to significantly get better morbidity or mortality rates than others.

It is mainly a system which is becoming ever larger, in part because pharmacological advances and technological advances have been so extraordinary that—especially with third-party subsidized payments, essentially, out of the Medicare system—you get huge demand; and my judgment is that because of this, we have a commitment to future retirees, under existing law, of medical services which could very well, as I indicated before, be a much larger demand on net real resources than we have the capacity to deliver.

So I would say it is an extraordinary problem to have, because there is no question that we are making huge advances in medical

technology, and the changes have enhanced American life, unquestionably, especially for the elderly.

Mrs. KELLY. Thank you, Mr. Greenspan.

Mr. Garrett?

Mr. GARRETT. Yes.

Thank you, Mr. Greenspan. I appreciate your being with us today, and also the times in the past.

Just one question, which is a follow-up question with regard to the GSE reform.

And I also appreciate your opening comment saying that when you first arrived, that you had a hard time getting your hands around exactly how they operate. So if you have that difficulty, then I feel a lot better myself, trying to figure out how they operate.

You had indicated already to one question with regard to the portfolio size your concerns about that and the concerns about this committee's lack of passing legislation that would address the growth in portfolio size.

And the question by Mr. Hensarling was regarding another significant portion of that bill, and that is that 5 percent portion, as far as adding to the housing stock in the country.

My question to you is: How do these two issues dovetail? And that is to say, with that 5 percent provision in there, is that just going to exacerbate the portfolio problem by putting any pressure or impetus on the industry to grow their portfolios so they——

Mr. GREENSPAN. Well, there are some who argue that because it is a percent of profits—and profits are very clearly a function of the proportion of purchased mortgages which are put in portfolios, as distinct from securitized—then clearly one could argue, and indeed many have argued, that the incentive there is to increase the size of portfolios in order to create the income.

But as I said before, we at the Federal Reserve have not taken a position on that particular aspect of the bill. That is not where our problems lie.

Mrs. KELLY. Thank you, Mr. Greenspan.

Mr. GARRETT. Your problems are in the portfolio side?

Mr. GREENSPAN. Correct.

Mr. GARRETT. Thank you.

Mrs. KELLY. Ms. Moore?

Ms. MOORE OF WISCONSIN. Thank you, Madam Chair.

Thank you so much for all your years of service, Mr. Greenspan.

You have indicated over and over again that you favor China revaluating its currency, and certainly in these halls there is huge debate about forcing them to do that. You said that they will do it for their own good.

There are many people who think that we are darned if they do and we are darned if they do not, that if in fact they stop providing the cheap loans to us and in fact sort of call some of their loans in in order to buoy up their economy, because people are living very frugally over there, that there will be a huge burst in our housing market, that interest rates will rise, that consumer spending will fall, and it will lead to a recession.

Do you agree that we are at risk, you know, particularly as we find ourselves pressing and pushing them to do this, that we could be at risk of seeing our economy fail?

Mr. GREENSPAN. Well, all I can say to you is that we have examined the issue of the impact of purchases of foreigners' of U.S. Treasury issues and the increase or decrease of those purchases on U.S. interest rates; and there is an effect, but it is not a very large effect, and the reason is that in the aggregate world markets, there are enough securities that compete with U.S. Treasuries, for example, that you do not get as large an impact as you would suspect.

But we do get an impact, there is no question about that.

Ms. MOORE OF WISCONSIN. And just very quickly, in terms of our low savings rate, do you think that a lot of thrust and call for these private accounts is based on sort of making up for the deficit——

Mrs. KELLY. The gentlewoman's time has expired.

Because of a prior agreement with Mr. Greenspan, and because we have been called for a vote, the chair is going to end this session with you, Mr. Greenspan.

We are honored to have you with us. We thank you very much for, every time you have been here, your great patience.

The chair notes that some members may have additional questions for this panel, which they may submit in writing.

Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses on the record.

This hearing is closed.

[Whereupon, at 1:01 p.m., the committee was adjourned.]

A P P E N D I X

July 20, 2005

Opening Statement

Chairman Michael G. Oxley

House Financial Services Committee

Semi-annual Monetary Policy Report and Testimony of Alan Greenspan, Chairman of the Federal Reserve Board of Governors

July 20, 2005

Chairman Greenspan, once again, we welcome you to the Financial Services Committee for now your 36th appearance before this Committee and our predecessor, the House Banking Committee, for the monetary policy report. I know I speak for all of our 70 Members when I say that your economic analysis and our discussion with you is a highlight of our calendar here at the Financial Services Committee. Welcome, once again.

We can report to the nation today that our U.S. economic growth is steady and strong. While we face some uncertainty abroad—-and we can be assured of the likelihood that there will always be uncertainty abroad—-our national economic performance is the envy of the world.

More Americans are working than ever before. We recently received the news that 146,000 jobs were created in June, achieving a five percent unemployment rate, the lowest since the fateful month of September, 2001. Not so long ago, many economists believed that there was a structural unemployment floor or six or seven percent. They didn't believe that our economy had the ability to reach the goal of five percent unemployment, and yet it has done so this month, with a total of 1.1 million jobs created this year.

An important leading indicator, durable goods, increased 5.5 percent in May, and U.S. manufacturing continues to expand at rates that exceed expectations. Our GDP is growing at a good clip of nearly four percent, and the important non-manufacturing sector has been increasing each month now for over two years. The markets have risen nicely, recovering from their post-bubble and post-9/11 declines and sell-offs, with the Dow now just 500 points shy of its historic high.

These positive economic conditions mean that more Americans than ever before have reached the goal of homeownership. With President Bush's housing policies and the American Dream Downpayment Act, homeownership will soon be within reach for even more American families.

With 14 consecutive quarters of economic growth, there is further good news for American consumers, and that is inflation has remained in check. The prices of goods and services did not go up during the month of June. Prices for businesses, the producer price index, actually went down slightly, indicating that businesses have been able to handle recent high energy prices.

Americans are well aware of the economy's steady growth, low inflation, and strong housing markets. Consumer confidence numbers are optimistic, and economic predictions show annual growth in the three- to four-percent range.

A thriving economy, growing businesses, and working Americans are the components of a healthy tax base and strong revenues. President Bush's tax cuts have been an important factor in the recent projection that the federal budget deficit will be far lower than previously expected, and that will help to keep interest rates as low as possible.

Over the long-term, President Bush's programs to make the tax cuts permanent, to restrain government spending, to ensure retirement security, and to expand U.S. exports through free trade will further enhance our economic success.

Chairman Greenspan, according to the Federal Reserve web site, its objectives include: "economic growth in line with the economy's potential to expand; a high level of employment; stable prices; and moderate long-term interest rates." It is an immense achievement that all of those objectives have been met, and we congratulate you.

You have the distinction of having served the Council of Economic Advisers under President Ford and serving as the Fed Chairman under every president since Reagan. Certainly the confidence of five presidents is also a testament to the nation's faith in your economic leadership. We thank you for your extraordinary service to your country and for the stalwart policies that have guided us to many years of prosperity. This success has advanced American business, has increased American influence throughout the world, and has created economic conditions in which American families thrive.

OPENING STATEMENT
CONGRESSMAN PETER T. KING
before the
HOUSE FINANCIAL SERVICES COMMITTEE

"Chairman Greenspan's Monetary Policy Report to Congress"

July 20, 2005

Welcome back, Chairman Greenspan. It is good to have you back at the Committee.

I am pleased that as we meet for your 36th appearance before this Committee, the economy in the United States remains strong. Unemployment is currently at 5%, the lowest rate since September 2001 and lower than the averages of the 70s, 80s, or 90s. Our economy created 146,000 jobs in June for a total of 1.1 million new jobs this year. This all comes at a time when inflation has remained low.

While these economic indicators are positive and the housing market remains strong, I am concerned about the impact of high oil prices on our economy. I am particularly interested in your insight as to what extent this phenomenon has affected our economy.

Thank you again for your service Chairman Greenspan. I look forward to your testimony.

For release on delivery
10:00 a.m. EDT
July 20, 2005

Statement of

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

July 20, 2005

Mr. Chairman and members of the Committee, I am pleased to be here to present the Federal Reserve's Monetary Policy Report to the Congress.

In mid-February, when I presented our last report to the Congress, the economy, supported by strong underlying fundamentals, appeared to be on a solid growth path, and those circumstances prevailed through March. Accordingly, the Federal Open Market Committee (FOMC) continued the process of a measured removal of monetary accommodation, which it had begun in June 2004, by raising the federal funds rate 1/4 percentage point at both the February and the March meetings.

The upbeat picture became cloudier this spring, when data on economic activity proved to be weaker than most market participants had anticipated and inflation moved up in response to the jump in world oil prices. By the time of the May FOMC meeting, some evidence suggested that the economy might have been entering a soft patch reminiscent of the middle of last year, perhaps as a result of higher energy costs worldwide. In particular, employment gains had slowed from the strong pace of the end of 2004, consumer sentiment had weakened, and the momentum in household and business spending appeared to have dissipated somewhat.

At the May meeting, the Committee had to weigh the extent to which this weakness was likely to be temporary--perhaps simply the product of the normal ebb and flow of a business expansion--and the extent to which it reflected some influence that might prove more persistent, such as the further run-up in crude oil prices. While the incoming data highlighted some downside risks to the outlook for economic growth, the FOMC judged the balance of information as suggesting that the economy had not weakened fundamentally.

Moreover, core inflation had moved higher again through the first quarter. The rising prices of energy and other commodities continued to place upward pressures on costs, and

reports of greater pricing power of firms indicated that they might be more able to pass those higher costs on to their customers. Given these considerations, the Committee continued the process of gradually removing monetary accommodation in May.

The data released over the past two months or so accord with the view that the earlier soft readings on the economy were not presaging a more serious slowdown in the pace of activity. Employment has remained on an upward trend, retail spending has posted appreciable gains, inventory levels are modest, and business investment appears to have firmed. At the same time, low long-term interest rates have continued to provide a lift to housing activity. Although both overall and core consumer price inflation have eased of late, the prices of oil and natural gas have moved up again on balance since May and are likely to place some upward pressure on consumer prices, at least over the near term. Slack in labor and product markets has continued to decline. In light of these developments, the FOMC raised the federal funds rate at its June meeting to further reduce monetary policy accommodation. That action brought the cumulative increase in the funds rate over the past year to 2-1/4 percentage points.

Should the prices of crude oil and natural gas flatten out after their recent run-up--the forecast currently embedded in futures markets--the prospects for aggregate demand appear favorable. Household spending--buoyed by past gains in wealth, ongoing increases in employment and income, and relatively low interest rates--is likely to continue to expand. Business investment in equipment and software seems to be on a solid upward trajectory in response to supportive conditions in financial markets and the ongoing need to replace or upgrade aging high-tech and other equipment. Moreover, some recovery in nonresidential construction appears in the offing, spurred partly by lower vacancy rates and rising prices for commercial properties. However, given the comparatively less buoyant growth of many foreign

economies and the recent increase in the foreign exchange value of the dollar, our external sector does not yet seem poised to contribute steadily to U.S. growth.

A flattening out of the prices of crude oil and natural gas, were it to materialize, would also lessen upward pressures on inflation. Overall inflation would probably drop back noticeably from the rates experienced in 2004 and early 2005, and core inflation could hold steady or edge lower. Prices of crude materials and intermediate goods have softened of late, and the slower rise in import prices that should result from the recent strength in the foreign exchange value of the dollar could also relieve some pressure on inflation.

Thus, our baseline outlook for the U.S. economy is one of sustained economic growth and contained inflation pressures. In our view, realizing this outcome will require the Federal Reserve to continue to remove monetary accommodation. This generally favorable outlook, however, is attended by some significant uncertainties that warrant careful scrutiny.

With regard to the outlook for inflation, future price performance will be influenced importantly by the trend in unit labor costs, or its equivalent, the ratio of hourly labor compensation to output per hour. Over most of the past several years, the behavior of unit labor costs has been quite subdued. But those costs have turned up of late, and whether the favorable trends of the past few years will be maintained is unclear. Hourly labor compensation as measured from the national income and product accounts increased sharply near the end of 2004. However, that measure appears to have been boosted significantly by temporary factors. Other broad measures suggest that hourly labor compensation continues to rise at a moderate rate.

The evolution of unit labor costs will also reflect the growth of output per hour. Over the past decade, the U.S. economy has benefited from a remarkable acceleration of productivity: Strong gains in efficiency have buoyed real incomes and restrained inflation. But experience

suggests that such rapid advances are unlikely to be maintained in an economy that has reached the cutting edge of technology. Over the past two years, growth in output per hour seems to have moved off the peak that it reached in 2003. However, the cause, extent, and duration of that slowdown are not yet clear. The traditional measure of the growth in output per hour, which is based on output as measured from the product side of the national accounts, has slowed sharply in recent quarters. But a conceptually equivalent measure that uses output measured from the income side has slowed far less. Given the divergence between these two readings, a reasonably accurate determination of the extent of the recent slowing in productivity growth and its parsing into cyclical and secular influences will require the accumulation of more evidence.

Energy prices represent a second major uncertainty in the economic outlook. A further rise could cut materially into private spending and thus damp the rate of economic expansion. In recent weeks, spot prices for crude oil and natural gas have been both high and volatile. Prices for far-future delivery of oil and gas have risen even more markedly than spot prices over the past year. Apparently, market participants now see little prospect of appreciable relief from elevated energy prices for years to come. Global demand for energy apparently is expected to remain strong, and market participants are evidencing increased concerns about the potential for supply disruptions in various oil-producing regions.

To be sure, the capacity to tap and utilize the world's supply of oil continues to expand. Major advances in recovery rates from existing reservoirs have enhanced proved reserves despite ever fewer discoveries of major oil fields. But, going forward, because of the geographic location of proved reserves, the great majority of the investment required to convert reserves into new crude oil productive capacity will need to be made in countries where foreign investment is currently prohibited or restricted or faces considerable political risk. Moreover, the

preponderance of oil and gas revenues of the dominant national oil companies is perceived as necessary to meet the domestic needs of growing populations. These factors have the potential to constrain the ability of producers to expand capacity to keep up with the projected growth of world demand, which has been propelled to an unexpected extent by burgeoning demand in emerging Asia.

More favorably, the current and prospective expansion of U.S. capability to import liquefied natural gas will help ease longer-term natural gas stringencies and perhaps bring natural gas prices in the United States down to world levels.

The third major uncertainty in the economic outlook relates to the behavior of long-term interest rates. The yield on ten-year Treasury notes, currently near 4-1/4 percent, is about 50 basis points below its level of late spring 2004. Moreover, even after the recent widening of credit risk spreads, yields for both investment-grade and less-than-investment-grade corporate bonds have declined even more than those on Treasury notes over the same period.

This decline in long-term rates has occurred against the backdrop of generally firm U.S. economic growth, a continued boost to inflation from higher energy prices, and fiscal pressures associated with the fast approaching retirement of the baby-boom generation.[1] The drop in long-term rates is especially surprising given the increase in the federal funds rate over the same period. Such a pattern is clearly without precedent in our recent experience.

The unusual behavior of long-term interest rates first became apparent last year. In May and June of 2004, with a tightening of monetary policy by the Federal Reserve widely expected,

[1] Under current law, those longer-run pressures on the federal budget threaten to place the economy on an unsustainable path. Large deficits could result in rising interest rates and ever-growing interest payments on the accumulating stock of debt, which in turn would further augment deficits in future years. That process could result in deficits as a percentage of gross domestic product rising without limit. Unless such a development were headed off, these deficits could cause the economy to stagnate or worse at some point over the next couple of decades.

market participants built large short positions in long-term debt instruments in anticipation of the increase in bond yields that has been historically associated with an initial rise in the federal funds rate. Accordingly, yields on ten-year Treasury notes rose during the spring of last year about 1 percentage point. But by summer, pressures emerged in the marketplace that drove long-term rates back down. In March of this year, long-term rates once again began to rise, but like last year, market forces came into play to make those increases short lived.

Considerable debate remains among analysts as to the nature of those market forces. Whatever those forces are, they are surely global, because the decline in long-term interest rates in the past year is even more pronounced in major foreign financial markets than in the United States.

Two distinct but overlapping developments appear to be at work: a longer-term trend decline in bond yields and an acceleration of that trend of late. Both developments are particularly evident in the interest rate applying to the one-year period ending ten years from today that can be inferred from the U.S. Treasury yield curve. In 1994, that so-called forward rate exceeded 8 percent. By mid-2004, it had declined to about 6-1/2 percent--an easing of about 15 basis points per year on average.[2] Over the past year, that drop steepened, and the forward rate fell 130 basis points to less than 5 percent.

Some, but not all, of the decade-long trend decline in that forward yield can be ascribed to expectations of lower inflation, a reduced risk premium resulting from less inflation volatility, and a smaller real term premium that seems due to a moderation of the business cycle over the past few decades.[3] This decline in inflation expectations and risk premiums is a signal

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[2] Dollar interest rate swaps five years forward and maturing in ten years declined 19 basis points per year on average over the same period. Comparable euro (pre-1999, Deutschemark) swaps declined 27 basis points, sterling swaps 35 basis points, and yen swaps 23 basis points.

[3] Term premiums measure the extent to which current prices of bonds discount future uncertainties.

development. As I noted in my testimony before this Committee in February, the effective productive capacity of the global economy has substantially increased, in part because of the breakup of the Soviet Union and the integration of China and India into the global marketplace. And this increase in capacity, in turn, has doubtless contributed to expectations of lower inflation and lower inflation-risk premiums.

In addition to these factors, the trend reduction worldwide in long-term yields surely reflects an excess of intended saving over intended investment. This configuration is equivalent to an excess of the supply of funds relative to the demand for investment. What is unclear is whether the excess is due to a glut of saving or a shortfall of investment. Because intended capital investment is to some extent driven by forces independent of those governing intended saving, the gap between intended saving and investment can be quite wide and variable. It is real interest rates that bring actual capital investment worldwide and its means of financing, global saving, into equality. We can directly observe only the actual flows, not the saving and investment tendencies. Nonetheless, as best we can judge, *both* high levels of intended saving and low levels of intended investment have combined to lower real long-term interest rates over the past decade.

Since the mid-1990s, a significant increase in the share of world gross domestic product (GDP) produced by economies with persistently above-average saving--prominently the emerging economies of Asia--has put upward pressure on world saving. These pressures have been supplemented by shifts in income toward the oil-exporting countries, which more recently have built surpluses because of steep increases in oil prices. The changes in shares of world GDP, however, have had little effect on actual world capital investment as a percentage of GDP. The fact that investment as a percentage of GDP apparently changed little when real interest

rates were falling, even adjusting for the shift in the shares of world GDP, suggests that, on average, countries' investment propensities had been declining.[4]

Softness in intended investment is also evident in corporate behavior. Although corporate capital investment in the major industrial countries rose in recent years, it apparently failed to match increases in corporate cash flow.[5] In the United States, for example, capital expenditures were below the very substantial level of corporate cash flow in 2003, the first shortfall since the severe recession of 1975. That development was likely a result of the business caution that was apparent in the wake of the stock market decline and the corporate scandals early this decade. (Capital investment in the United States has only recently shown signs of shedding at least some of that caution.) Japanese investment exhibited prolonged restraint following the bursting of their speculative bubble in the early 1990s. And investment in emerging Asia excluding China fell appreciably after the Asian financial crisis in the late 1990s. Moreover, only a modest part of the large revenue surpluses of oil-producing nations has been reinvested in physical assets. In fact, capital investment in the Middle East in 2004, at 25 percent of the region's GDP, was the same as in 1998. National saving, however, rose from 21 percent to 32 percent of GDP. The unused saving of this region was invested in world markets.

Whether the excess of global intended saving over intended investment has been caused by weak investment or excessive saving--that is, by weak consumption--or, more likely, a combination of both does not much affect the intermediate-term outlook for world GDP or, for

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[4] Nominal GDP figures by country are estimated in dollars by the International Monetary Fund using purchasing power parities (PPP) of currencies. These GDP figures are used to calculate weights applied to national saving and investment rates to form global measures. When the GDP figures are instead measured at market exchange rates, the results are similar. The PPP estimates emphasize the economic factors generating investment and the use of saving. Exchange rates emphasize the financial forces governing the financing of investment across borders. Both approaches are useful.

[5] A significant part of the surge in cash flow of U.S. corporations was accrued by those financial intermediaries that invest only a small part in capital assets. It appears that the value added of intermediation has increased materially over the past decade because of major advances in financial product innovation.

that matter, U.S. monetary policy. What have mattered in recent years are the sign and the size of the gap of intentions and the implications for interest rates, not whether the gap results from a saving glut or an investment shortfall. That said, saving and investment propensities do matter over the longer run. Higher levels of investment relative to consumption build up the capital stock and thus add to the productive potential of an economy.

The economic forces driving the global saving-investment balance have been unfolding over the course of the past decade, so the steepness of the recent decline in long-term dollar yields and the associated distant forward rates suggests that something more may have been at work over the past year.[6] Inflation premiums in forward rates ten years ahead have apparently continued to decline, but real yields have also fallen markedly over the past year. It is possible that the factors that have tended to depress real yields over the past decade have accelerated recently, though that notion seems implausible.

According to estimates prepared by the Federal Reserve Board staff, a significant portion of the sharp decline in the ten-year forward one-year rate over the past year appears to have resulted from a fall in term premiums. Such estimates are subject to considerable uncertainty. Nevertheless, they suggest that risk takers have been encouraged by a perceived increase in economic stability to reach out to more distant time horizons. These actions have been accompanied by significant declines in measures of expected volatility in equity and credit markets inferred from prices of stock and bond options and narrow credit risk premiums. History cautions that long periods of relative stability often engender unrealistic expectations of its permanence and, at times, may lead to financial excess and economic stress.

[6] The decline of euro, sterling, and yen forward swap rates also steepened.

Such perceptions, many observers believe, are contributing to the boom in home prices and creating some associated risks. And, certainly, the exceptionally low interest rates on ten-year Treasury notes, and hence on home mortgages, have been a major factor in the recent surge of homebuilding, home turnover, and particularly in the steep climb in home prices. Whether home prices on average for the nation as a whole are overvalued relative to underlying determinants is difficult to ascertain, but there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels. Among other indicators, the significant rise in purchases of homes for investment since 2001 seems to have charged some regional markets with speculative fervor.

The apparent froth in housing markets appears to have interacted with evolving practices in mortgage markets. The increase in the prevalence of interest-only loans and the introduction of more-exotic forms of adjustable-rate mortgages are developments of particular concern. To be sure, these financing vehicles have their appropriate uses. But some households may be employing these instruments to purchase homes that would otherwise be unaffordable, and consequently their use could be adding to pressures in the housing market. Moreover, these contracts may leave some mortgagors vulnerable to adverse events. It is important that lenders fully appreciate the risk that some households may have trouble meeting monthly payments as interest rates and the macroeconomic climate change.

The U.S. economy has weathered such episodes before without experiencing significant declines in the national average level of home prices. Nevertheless, we certainly cannot rule out declines in home prices, especially in some local markets. If declines were to occur, they likely would be accompanied by some economic stress, though the macroeconomic implications need not be substantial. Nationwide banking and widespread securitization of mortgages make

financial intermediation less likely to be impaired than it was in some previous episodes of regional house-price correction. Moreover, a decline in the national housing price level would need to be substantial to trigger a significant rise in foreclosures, because the vast majority of homeowners have built up substantial equity in their homes despite large mortgage-market-financed withdrawals of home equity in recent years.

Historically, it has been rising real long-term interest rates that have restrained the pace of residential building and have suppressed existing home sales, high levels of which have been the major contributor to the home equity extraction that arguably has financed a noticeable share of personal consumption expenditures and home modernization outlays.

The trend of mortgage rates, or long-term interest rates more generally, is likely to be influenced importantly by the worldwide evolution of intended saving and intended investment. We at the Federal Reserve will be closely monitoring the path of this global development few, if any, have previously experienced. As I indicated earlier, the capital investment climate in the United States appears to be improving following significant headwinds since late 2000, as is that in Japan. Capital investment in Europe, however, remains tepid. A broad worldwide expansion of capital investment not offset by a rising worldwide propensity to save would presumably move real long-term interest rates higher. Moreover, with term premiums at historical lows, further downward pressure on long-term rates from this source is unlikely.

* * *

We collectively confront many risks beyond those that I have just mentioned. As was tragically evidenced again by the bombings in London earlier this month, terrorism and geopolitical risk have become enduring features of the global landscape. Another prominent concern is the growing evidence of anti-globalization sentiment and protectionist initiatives,

which, if implemented, would significantly threaten the flexibility and resilience of many economies. This situation is especially troubling for the United States, where openness and flexibility have allowed us to absorb a succession of large shocks in recent years with only minimal economic disruption. That flexibility is, in large measure, a testament to the industry and resourcefulness of our workers and businesses. But our success in this dimension has also been aided importantly by more than two and a half decades of bipartisan effort aimed at reducing unnecessary regulation and promoting the openness of our market economy. Going forward, policymakers will need to be vigilant to preserve this flexibility, which has contributed so constructively to our economic performance in recent years.

In conclusion, Mr. Chairman, despite the challenges that I have highlighted and the many I have not, the U.S. economy has remained on a firm footing, and inflation continues to be well contained. Moreover, the prospects are favorable for a continuation of those trends. Accordingly, the Federal Open Market Committee in its June meeting reaffirmed that it "... believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

THE PROBLEM OF EXECUTIVE COMPENSATION
Prepared by Democratic Staff, House Financial Services Committee
April 18, 2005

In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging. [1]

- Warren Buffett

Executive Compensation Has Grown Exponentially

According to a recent *USA Today* report[2], the *median* CEO compensation in 2004 was $14 million, up 25% from 2003. (One CEO even pocketed $84 million exercising options, and received new grants worth more than $130 million). In comparison, the same study found that the average rank-and-file worker's pay increased 2.5%. Unfortunately, compared to recent years, 2004 is hardly exceptional: the CEOs of S&P 500 firms earned a median of 11.5 % more in 2002 than in 2001 and 27.2 % more in 2003 than in 2002.[3]

This disparity has grown significantly over the last few years. In 1991, the average large-company CEO received approximately 140 times the pay of an average worker; in 2003, the ratio was about 500:1.[4] The amounts have risen so far so fast, that they can no longer be explained by traditional valuations. Even when adjusting for other variables (e.g., company size, performance, industry classification, inflation), studies find executive compensation is far higher today than in the early 1990s.[5]

Executive Compensation Is a Significant Cost to Shareholders and the Economy

While these numbers are themselves concerning, they also reflect real costs to shareholders and the economy. In 1993, the aggregate compensation paid to the top five executives of U.S. public companies represented 4.8% of company profits; *by 2003 the ratio had more than doubled to 10.3%.* [6] and the total amount paid to these executives during this period is roughly $290 billion[7] (that is *ten times* the 2005 discretionary budget for the Department of Homeland Security).

These compensation figures also dwarf the costs of complying with Section 404 of the Sarbanes-Oxley Act. As noted in yesterday's *New York Times*:

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[1] Letter to Berkshire Hathaway Shareholders (http://www.berkshirehathaway.com/letters/2003ltr.pdf)
[2] "Special Report: CEO Pay 'Business as Usual,'" *USA Today*, Mar. 30, 2005 (http://www.usatoday.com/money/companies/management/2005-03-30-ceo-pay-2004-cover_x.htm).
[3] http://www.thecorporatelibrary.com/
[4] Lucian Bebchuk, Pay Without Performance (2004).
[5] Lucian Bebchuk and Yaniv Grinstein, "The Growth in Executive Pay" (Discussion Draft, 2005) ("During this period [1993-2003], pay has grown much beyond the increase that could be explained by changes in firm size, performance and industry classification. Had the relationship of compensation to size, performance and industry classification remained the same in 2003 as it was in 1993, mean compensation in 2003 would have been only about half of its actual size.") (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=648682).
[6] *Id.*
[7] *Id.*

"Executives at the roundtable consistently said that complying with Section 404 has been more expensive than they had anticipated, and they questioned whether the benefit - which no one has been able to quantify - is worth the cost.

There are, perhaps unsurprisingly, several studies of the cost of compliance from various business groups. Financial Executives International, a networking and advocacy organization, said last month that a survey of 217 publicly traded companies showed they had spent $4.36 million, on average, to comply with Section 404.

A different survey, of 90 clients of the Big Four accounting firms - Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers - found that the companies spent an average of $7.8 million on compliance. That was about 0.10 percent of their revenue, and less than the $9.8 million paid, on average, to C.E.O.'s at 179 companies whose annual filings were surveyed earlier this month in Sunday Business.

The accounting firms noted that as companies become more familiar with Section 404, the amount they spend to comply with it may drop this year, by as much as 46 percent, according to the survey."[8]

While Sarbanes-Oxley costs will naturally fall in the coming years (as companies become more familiar with its requirements and their internal controls), there is no evidence that executive compensation will suddenly follow suit.

Many Compensation Schemes Create Perverse Incentives For Executives to Shirk Duty to Shareholders

In addition to concerns about the sheer size, these compensation schemes may actually give executives a perverse incentive to shirk their fiduciary duty to shareholders in a number of ways, for example:

Earnings Manipulation. Putting aside outright earnings fraud, because accounting standards like FAS 133 are not always clear, excessive compensation (particularly enormous bonuses based on meeting "Wall Street expectations") give executives an incentive to use "aggressive" accounting methods that maximize his/her compensation.[9] Years (or months) later, when the company is forced to restate its earnings – and shareholder value plummets – the executives retain their bonuses.[10]

Unprofitable Mergers/Acquisitions. Because senior executives often receive *additional* compensation when they buy a new company or sell their current one (and are responsible for negotiating the overall deal), there is a natural conflict of interest between the executives' interest (i.e. closing the deal and obtaining his/her "golden parachute") and the company's interest (i.e. maximizing shareholder value). For example:

- James Kilts will make $153 million in the merger of Gillette and Procter & Gamble.[11]

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[8] "Here It Comes: The Sarbanes-Oxley Backlash," *New York Times*, Apr. 17, 2005.
[9] See, e.g., Lucian Bebchuk and Jesse Fried, "Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay and Camouflage" (Discussion Draft). (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=653125).
[10] See, e.g., "Sorry, I'm Keeping the Bonus Anyway" *New York Times*, Mar. 13, 2005.
[11] "No Razor Here: Gillette Chief to Get a Giant Payday," *Wall Street Journal*, Jan. 31, 2005; see also "Review Raises New Questions on Gillette Sale," *Boston Globe*, Mar. 22, 2005.

- John Zeglis, former CEO of AT&T Wireless, made $32 million when the company was sold to Cingular for $15 dollars a share—which was half the price of the stock when the company went public in 2000.[12]

- Top executives at AT&T stand to make $31 million (including $10.3 million to CEO David Dorman) if its deal to be acquired by SBC goes through as planned.[13]

- When Harrah's acquired Caesar's Entertainment last year, Caesar's CEO Wallace Barr received nearly $20 million.[14]

- Wallace D. Mallone Jr., CEO of SouthTrust to earn $59 million in termination awards, stock awards and options over the next five years if he leaves the bank, along with an annual pension of $3.8 million in the merger of SouthTrust and Wachovia.[15]

Studies of mergers have found that target CEOs were willing to accept lower acquisition premiums when the acquirer promised them high-ranking managerial post after the acquisition.[16] Why would similar results not follow when CEOs receive direct monetary compensation?

Camouflaging Compensation. Even senior executives and boards' actions suggest that compensation is *per se* excessive: why else would they go to such lengths to avoid shareholder scrutiny and hide executive compensation?

Growth In Compensation Is Not Tied To Performance

As our Committee has seen first hand, even executives of institutions that lose money, restate earnings, and face extensive regulatory scrutiny have received (and retained) substantial compensation packages. After being forced out of Fannie Mae because the company used faulty accounting – and announced a $9 billion restatement that could go up – Former Fannie Mae, CEO Frank Raines will receive a pension worth roughly $1.4 million per year for life and prorated portions of incentive stock awards that could be worth millions of dollars.[17] Unfortunately, Raines is hardly the exception.

- On Saturday, the New York Times reported that the top three executives at Viacom (CEO Summer Redstone, and co-presidents, Tom Freston and Leslie Moonves) received at total compensation of $160 million last year. They reported the information Friday afternoon, after the market closed. Viacom lost $17.5 billion and its share price fell 18 percent last year.[18]

---

[12] *Id.*
[13] "AT&T Execs Would Receive $31 M in SBC Sale", *Associated Press*, Mar. 12, 2005.
[14] "No Wonder CEOs Love Those Mergers," *New York Times*, July 18, 2004.
[15] *Id.*
[16] See Hartzell, Ofek and Yermack, "What's In It For Me? CEOs Whose Firms Are Acquired." *Review of Financial Studies* 17: 37-61 (2004); and Julie Wulf "Do CEOs in Mergers Trade Power for Premium? Evidence from 'Mergers of Equals,'" *Journal of Law, Economics & Organization* 20 (2004): 60-101.
[17] See, "Fannie Mae Exit Packages Face Review," *Washington Post*, Dec. 23, 2004. http://www.washingtonpost.com/wp-dyn/articles/A21132-2004Dec22.html
[18] "While Shares Fell, Viacom Paid Three $160 Million," *New York Times*, Apr. 16, 2005.

- HP paid outgoing CEO Carly Fiorina a severance package of $21 million (and within a month paid incoming CEO Mark Hurd a $20 million "welcoming package").[19]

- Former Disney President Michael Ovitz made $140 million in 1996 after only 14 months on the job.[20]

- US Airways CEO David Siegal collected $4.5 million upon leaving as the carrier faced its second bankruptcy.[21]

- Procter & Gamble CEO Durk Jager left the company with over $9.5 million package after overseeing a 55% drop in share price.[22]

Few Remedies Exist Currently for Shareholders to Challenge Executive Compensation

Because the SEC has thus far deadlocked on its proposal to provide shareholders direct access to management's proxy, shareholders have few options for addressing excessive executive compensation. Other legislative or regulatory action may be needed.

> *"'Shareholders have little influence, if any, because directors literally can't not be elected...Most are chosen by boards, and there are the same number as board seats. It's like the communist election system: You can't lose.'*[23]
>
> *Until regulators require companies to provide more disclosure on pay practices and open up director elections, boards are under no pressure to change, governance experts say."*[24]

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[19] "Our Opinions: CEO Rakes In Money For Nothing," *Atlanta Journal Constitution,* Apr. 4, 2005.
[20] "Take That Handshake and Shove It!: Carly Fiorina's Payoff Share Not Fair," *Pittsburgh Post Gazette*, Feb. 20, 2005.
[21] *Id.*
[22] "Platinum Chutes Gives Fired CEOs a Heavenly Ride," *Chicago Tribune*, Sept. 16, 2000.
[23] Carol Bowie, IRRC Governance Research Chief. Quoted in "CEO Pay, Business as Usual."
[24] "CEO Pay, Business as Usual."

The Evolution of Diminishing Expectations:
Bush Administration Job Projections and Actual Job Creation
June 2003 through June 2005
(prepared by Democratic Staff, House Financial Services Committee)

305,000 jobs per month ***projected***, July 2003 through December 2004.[1]
144,000 jobs per month ***created*** during this period.

200,000 jobs per month ***projected***, October 2003 through September 2004.[2]
161,000 jobs per month ***created*** during this period.

325,000 jobs per month ***projected*** for 2004.[3]
182,000 jobs per month ***created*** for 2004.

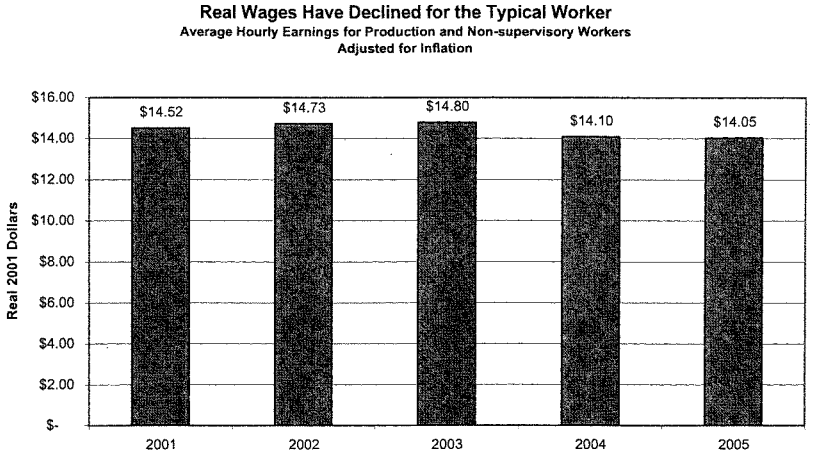
175,000 jobs per month ***projected*** for 2005.[4]
181,000 jobs per month ***created*** so far this year.

During the past two years (June 2003 through June 2005), average monthly job growth has been 148,000.

---

[1] Source: Council of Economic Advisors, "Strengthening America's Economy: The President's Jobs and Growth Proposals," February 4, 2003. Based on projection of 5.5 million jobs created over 18 months.
[2] Source: NYT On-line, "Snow Boasts Spring Has Sprung for US Economy." Projection by Treasury Secretary John Snow.
[3] The 2004 Economic Report of the President projected that the average number of jobs in the economy for 2004 would be 132.7 million, compared to an average of 130.1 million for 2003. Although these projections were reported as a 2.6 million job increase for 2004, or 216,000 jobs created per month, this was not accurate. If the economy only added 216,000 jobs per month throughout 2004, then total jobs in the economy would reach 132.7 million by the *end* of 2004, but it would not average 132.7 million for the *entire* year. In order to achieve an average of 132.7 million for the entire year, the economy would need to add something in the range of 320,000 – 325,000 jobs per month, a number that White House staff acknowledged in a February 10, 2004 Financial Times article. In order to avoid the confusion that accompanied the 2004 forecast, the CEA's 2005 forecast for the first time included a projection for average monthly job creation.

[4] 2005 Economic Report of the President.



Prepared by the Democratic Staff of the House Financial Services Committee, July 20, 2005.

The New York Times
nytimes.com

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July 18, 2005

The Dropout Puzzle

By PAUL KRUGMAN

Many seemingly authoritative figures, not all of them partisan shills, say that the American economy has fully recovered from the recession that began in 2001. They point to the unemployment rate, which has fallen from a peak of 6.3 percent in 2003 to 5 percent last month. That's not quite as low as the 4.2 percent unemployment rate in February 2001, when the recession began, but it's fairly low by historical standards.

For some reason, however, the public isn't feeling prosperous. Gallup tells us that only 3 percent of Americans describe the economy as "excellent," and only 33 percent describe it as "good."

Maybe people are just ungrateful. Maybe they've been misled by negative media reports. Maybe they're grumpy about their paychecks: adjusted for inflation, average weekly earnings have been flat for the past five years.

Or maybe the figures on unemployment are giving a false signal.

Economists who argue that there's something wrong with the unemployment numbers are buzzing about a new study by Katharine Bradbury, an economist at the Federal Reserve Bank of Boston, which suggests that millions of Americans who should be in the labor force aren't. "The addition of these hypothetical participants," she writes, "would raise the unemployment rate by one to three-plus percentage points."

Some background: the unemployment rate is only one of several numbers economists use to assess the jobs picture. When the economy is generating an abundance of jobs, economists expect to see strong growth in the payrolls reported by employers and in the number of people who say they have jobs, together with a rise in the length of the average workweek. They also expect to see wage gains well in excess of inflation, as employers compete to attract workers.

In fact, we see none of these things. As Berkeley's J. Bradford DeLong writes on his influential economics blog, "We have four of five indicators telling us that the state of the job market is not that good and only one - the unemployment rate - reading green."

In particular, even the most favorable measures show that employment growth has lagged well behind population growth over the past four years. Yet the measured unemployment rate isn't much higher than it was in early 2001. How is that possible?

The answer, according to the survey used to estimate the unemployment rate, is a decline in labor force participation. Nonworking Americans aren't considered unemployed unless they are actively looking for work, and hence counted as part of the labor force. And a large number of people have, for some reason, dropped out of the official labor force.

Those with a downbeat view of the jobs picture argue that the low reported unemployment rate is a statistical illusion, that there are millions of Americans who would be looking for jobs if more jobs were available. Those with an upbeat view argue that labor force participation has fallen for reasons that have nothing to do with job availability - for example, young adults, recognizing the importance of education, may have chosen to stay in school longer.

That's where Dr. Bradbury's study comes in. She shows that the upbeat view doesn't hold up in the face of a careful examination of the numbers. In fact, because older Americans, especially older women, are more likely to work than in the past, labor force participation should have risen, not fallen, over the past four years. As a result, she suggests that there may be "considerable slack in the U.S. labor market": there are at least 1.6 million and possibly as many as 5.1 million people who aren't counted as unemployed but would take jobs if they were available.

There's both good news and bad news in that assessment. The good news is that the economy probably has plenty of room to expand before inflation becomes a problem (which implies that the Fed's decision to start raising interest rates was premature).

The bad news is that it's hard to see where further expansion will come from. We've already had four years of extremely loose fiscal and monetary policy. Tax cuts have pushed the federal budget deep into the red. Low interest rates have helped generate a housing bubble that has lifted real estate prices to ludicrous heights in major parts of the country.

If all that wasn't enough to give us a full economic recovery, what will?

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July 21, 2005

The Honorable Alan Greenspan
Chairman
Federal Reserve System
Board of Governors
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Dear Mr. Chairman:

Thank you for testifying before the House Financial Services Committee on July 20 and presenting us with the Federal Reserve System's latest monetary policy report. We in Congress value your guidance on economic policy matters.

Due to lack of time, I was not able to ask any questions during the hearing, but I would appreciate your response in writing to the following questions:

1) Some of my colleagues in the House have expressed serious concern regarding the amount of U.S. government debt financed by foreign countries through their holdings of U.S. Treasury securities. Does the increase in foreign purchase of Treasury securities impact the U.S. economy, or is there little difference whether that debt is purchased by domestic or foreign buyers? Additionally, do you believe there sufficient buyers to finance the current level of U.S. debt?

2) With the Chinese central bank's move toward a more flexible exchange rate system, what effect will the float of the yuan have on China's purchase of U.S. debt through Treasury securities?

Thank you for your many years of distinguished service to our country.

Sincerely,

Randy Neugebauer

Randy Neugebauer

RN/krb

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

August 18, 2005

The Honorable Randy Neugebauer
House of Representatives
Washington D.C. 20515

Dear Congressman:

I am pleased to enclose my response to the questions you submitted following the hearing entitled, "Monetary Policy and the State of the Economy" before the House Committee on Financial Services.

I have also forwarded a copy of this response to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Greenspan subsequently submitted the following in response to a written question received from Congressman Randy Neugebauer in connection with the hearing on July 20, 2005, before the House Committee on Financial Services:

1. Does the increase in foreign purchase of Treasury securities impact the U.S. economy, or is there little difference whether that debt is purchased by domestic or foreign buyers? Additionally, do you believe there sufficient buyers to finance the current level of U.S. debt?

Since the late 1900s, a substantial inflow of foreign capital has helped to maintain productivity-enhancing investment in the United States. Whether the inflow occurs through purchases of Treasury securities or purchases of other U.S. assets may have some effect on Treasury yields relative to other yields, but this effect is likely to be modest given the enormous depth and liquidity of U.S. financial markets. Government bond yields are also low now in many foreign countries, suggesting that global developments, such as the evolution of global savings relative to investment, are likely the most important contributors to the low Treasury yields that we currently observe.

2. With the Chinese central bank's move toward a more flexible exchange rate system, what effect will the float of the yuan have on China's purchase of U.S. debt through Treasury securities.

It is difficult to predict the future development of China's exchange rate regime. However, it seems likely that changes in this regime, including changes in the pattern of China's purchases of U.S. assets, will be gradual.

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

Submitted pursuant to section 2B of the Federal Reserve Act

July 20, 2005

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 20, 2005

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to section 2B of the Federal Reserve Act.

Sincerely,

Alan Greenspan, Chairman

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Monetary Policy Report to the Congress

Report submitted to the Congress on July 20, 2005, pursuant to section 2B of the Federal Reserve Act

Monetary Policy and the Economic Outlook

The U.S. economy continued to expand at a solid pace over the first half of 2005 despite the restraint imposed on aggregate demand by a further rise in crude oil prices. Household spending trended up, propelled by rising wealth and income and by low interest rates, and business outlays received ongoing support from favorable financial conditions, rising sales, and increased profitability. Moreover, the earlier declines in the foreign exchange value of the dollar shifted some domestic and foreign demand toward U.S. producers. Overall, the economic expansion was sufficient to create jobs at roughly the same pace as in late 2004 and to lower the unemployment rate further over the first half of this year.

Higher oil prices boosted retail prices of a broad range of consumer energy products and, as a result, continued to hold up the rate of overall consumer price inflation in the first half of 2005. In addition, the rise in energy prices this year, coupled with increases in the prices of some other commodities, imported goods, and industrial materials, put upward pressure on the costs of many businesses. A portion of these costs was passed on to consumers, which contributed to a higher rate of inflation in core consumer prices (that is, total prices excluding the food and energy components, which are volatile). As measured by the price index for personal consumption expenditures excluding food and energy, core inflation increased from an annual rate of 1½ percent in 2004 to about 2 percent between the fourth quarter of 2004 and May 2005. While survey measures of near-term inflation expectations have edged up this year, surveys, as well as readings from financial markets, suggest that expected inflation at longer horizons has remained contained.

With financial conditions advantageous for households and firms, a solid economic expansion in train, and some upward pressure on inflation, the Federal Open Market Committee (FOMC) continued to remove policy accommodation at a measured pace over the first half of the year, raising the intended federal funds rate an additional 1 percentage point, to 3¼ percent, by the end of June. At the most recent FOMC meeting, the Committee judged that policy remained accommodative. With appropriate monetary policy, however, the upside and downside risks to output and inflation were viewed as balanced, and the Committee underscored its commitment to respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The fundamental factors that supported the U.S. economy in the first half of 2005 should continue to do so over the remainder of 2005 and in 2006. In the household sector, the combination of further gains in employment, favorable borrowing terms, and generally healthy balance sheets should keep consumer spending and residential investment on an upward path. In the business sector, expanding sales, the low cost of capital, and the replacement or upgrade of aging equipment and software should help to maintain increases in capital spending. And, although economic performance has been uneven across countries, continued growth overall in the economies of U.S. trading partners should sustain the demand for U.S. exports. In contrast, ongoing increases in imports will likely continue to subtract from the growth of U.S. gross domestic product. In addition, high energy prices remain a drag on aggregate demand both here and abroad, though this drag should lessen over time if prices for crude oil level out in line with quotes in futures markets.

Despite the upward pressure on costs and prices over the past year or so, core consumer price inflation is likely to remain contained in 2005 and 2006. Longer-run inflation expectations are still well anchored, and because businesses are adding to their stocks of capital and are continuing to find ways to use their capital and work forces more effectively, structural productivity will likely rise at a solid pace over the foreseeable future. In addition, barring a further increase in oil prices, the boost that higher energy costs have given to core inflation should wane in coming quarters, while the recent appreciation of the dollar, as well as the deceleration in global materials prices, will likely reduce the impetus to inflation from rising import prices.

Of course, substantial uncertainties surround this economic outlook. A further sharp rise in crude oil prices would have undesirable consequences for both economic activity and inflation, and the possibility that housing prices, at least in some locales, have moved above levels that can be supported by fundamentals remains a concern. As another example, if the recent surge in measured

unit labor costs were to prove more persistent than currently appears likely, the outlook for inflation would be adversely affected. Economic growth and inflation will also be shaped importantly by the evolution of the imbalance in the U.S. current account.

The Conduct of Monetary Policy over the First Half of 2005

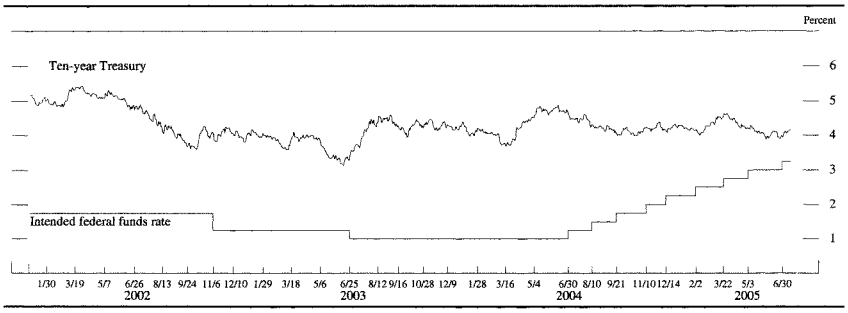
Despite increases in the federal funds rate totaling 1¼ percentage points in 2004, monetary policy was still judged to be accommodative at the start of 2005. At the time of the February FOMC meeting, the available information indicated that the economy had expanded at a robust pace through the end of 2004 and retained considerable momentum. Accordingly, the Committee voted to raise its target for the federal funds rate from 2¼ percent to 2½ percent and to make minimal changes to the text of the accompanying statement. The statement reiterated that "the Committee believes that policy accommodation can be removed at a pace that is likely to be measured." Members noted, however, that this forward-looking language was clearly conditioned on economic developments and therefore would not stand in the way of either a pause or a step-up in policy firming depending on events.

By March, the data were pointing to a further solid gain in activity during the first quarter, fueled especially by continued increases in consumption expenditures and residential investment. In addition, private nonfarm payrolls were posting widespread advances, and slack in resource utilization appeared to be diminishing. The Committee voted at its March meeting to raise the federal funds rate another 25 basis points, to 2¾ percent. In view of the rise in prices of energy and other commodities and recent elevated readings on inflation in core consumer prices, the Committee altered the text of the policy statement to note the pickup in inflationary pressures. The Committee also decided to modify the assessment of the balance of risks to make it explicitly conditional on an assumption of "appropriate" monetary policy, so as to underscore that maintaining balanced risks would likely require continued removal of policy accommodation.

The evidence that had accumulated by the spring pointed to some moderation in the pace of activity. Retail spending flattened out for a time, likely in response to higher energy prices, and the growth of capital spending dropped back from its elevated pace of late last year. Nonetheless, with long-term interest rates still quite low and with employment and profits continuing to rise, economic activity appeared to retain considerable momentum, suggesting that the softness would be short lived. Against this backdrop, the FOMC decided to raise the federal funds rate another 25 basis points at its May meeting and to make few changes to the text of the accompanying statement.

In the weeks after the May meeting, incoming indicators supported the view that the underlying pace of activity was not faltering. The information that the Committee reviewed at the time of the June FOMC meeting showed that consumer spending and business investment had turned up, on balance, and that demand for housing continued to be strong. With economic activity remaining firm and crude oil prices ratcheting higher, the FOMC

Selected interest rates



NOTE: The data are daily and extend through July 13, 2005. The ten-year Treasury rate is the constant-maturity yield based on the most actively traded securities. The dates on the horizontal axis are those of FOMC meetings.
SOURCE: Department of the Treasury and the Federal Reserve.

voted to raise the funds rate an additional 25 basis points, to 3¼ percent, and to make only minimal changes to the text of the accompanying statement. This action brought the cumulative increase in the target federal funds rate since June 2004 to 2¼ percentage points.

Economic Projections for 2005 and 2006

In conjunction with the FOMC meeting at the end of June, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, were asked to provide economic projections for 2005 and 2006. In general, Federal Reserve policymakers expect the economy to continue to expand at a moderate pace and core inflation to remain roughly stable over this period. The central tendency of the FOMC participants' forecasts for the increase in real (that is, inflation adjusted) GDP is 3½ percent over the four quarters of 2005 and 3¼ percent to 3½ percent in 2006. The civilian unemployment rate is expected to average 5 percent in both the fourth quarter of 2005 and the fourth quarter of 2006. FOMC participants project that the chain-type price index for personal consumption expenditures excluding food and energy will increase between 1¾ percent and 2 percent both this year and next.

Economic projections for 2005 and 2006

Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents	
	Range	Central tendency
	2005	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	5–6¼	5½–5¾
Real GDP	3–3¾	3½
PCE price index excluding food and energy	1½–2¼	1¾–2
Average level, fourth quarter		
Civilian unemployment rate	5–5¼	5
	2006	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	5–6	5¼–5½
Real GDP	3¼–3¾	3¼–3½
PCE price index excluding food and energy	1½–2½	1¾–2
Average level, fourth quarter		
Civilian unemployment rate	5	5

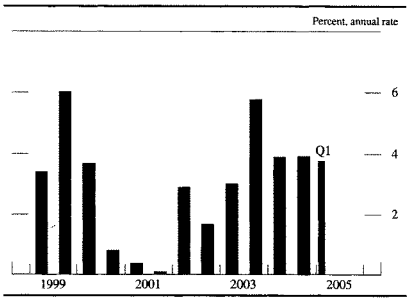
1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

Economic and Financial Developments in 2005

The economic expansion entered 2005 on a solid footing and was led by ongoing increases in consumption, residential investment, and business spending on equipment and software. Although the pace of expansion slowed somewhat in the early spring, activity has picked up again more recently. On average, real GDP appears to have increased a little less rapidly over the first half of 2005 than in the second half of 2004, a reflection in part of reduced fiscal stimulus and the drag on economic activity from higher energy prices. Industrial production has also risen more slowly so far this year than in 2004: The increase totaled 3 percent at an annual rate between December 2004 and June 2005, down from 5 percent during the previous six months. Nevertheless, the economic expansion has been sufficient to gradually absorb slack in labor and product markets. Nonfarm payroll employment has continued to increase, and the unemployment rate has moved down further since the beginning of the year, to 5 percent in June. Similarly, the rate of capacity utilization in the manufacturing sector stood at 78.4 percent in June, up from 77.9 percent at the end of 2004 and just a little below its long-term historical average.

Rising energy prices continued to boost consumer price inflation in the first half of 2005. With consumer energy prices having climbed more than 13 percent at an annual rate so far this year, the price index for personal consumption expenditures (PCE) increased at an annual rate of about 2½ percent between the fourth quarter of 2004 and May 2005, the same pace as in 2004. Meanwhile, the core PCE price index rose at an annual rate of about

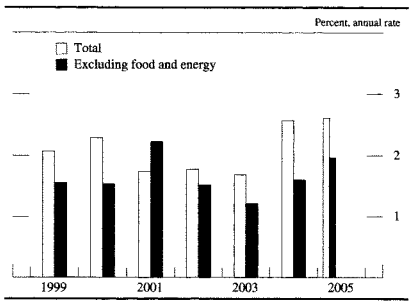
Change in real GDP



NOTE: Here and in subsequent charts, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.

SOURCE: Department of Commerce, Bureau of Economic Analysis.

Change in PCE chain-type price index



NOTE: The data are for personal consumption expenditures (PCE). The changes for 2005 are from 2004:Q4 to May 2005.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

2 percent in the first half of 2005, up from 1½ percent in 2004.

The Household Sector

Consumer Spending

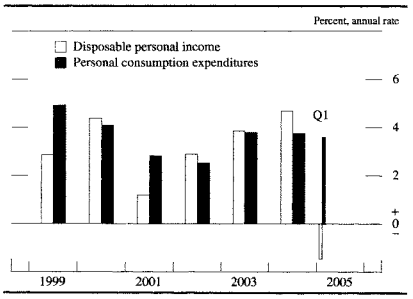
Consumer spending continued to move higher in the first half of this year, though not as rapidly as in the second half of 2004. After increasing at an average annual rate of 4½ percent in the third and fourth quarters of last year, real personal consumption expenditures rose at a 3½ percent rate in the first quarter and appear to have advanced at a roughly similar pace in the second quarter. Household spending this year has been supported by rising employment and household wealth as well as by the low level of interest rates. However, higher costs for consumer energy products have eroded households' purchasing power.

Sales of light motor vehicles, which had been buoyed in the second half of last year by a variety of sales inducements, dropped back in the first quarter after many of the inducements expired. However, sales firmed again in the second quarter to an average annual pace of more than 17 million units, a level similar to that in the fourth quarter of last year. Underlying demand for light motor vehicles has remained relatively strong, though sales likely have also been boosted recently by sizable price discounts.

Excluding motor vehicles, consumer spending posted strong gains in early 2005, flattened out in March, and picked up again in the spring. On a quarterly average basis, the rate of increase in non-auto spending appears to have stepped down in the second quarter, largely because of a deceleration in outlays for consumer goods. Meanwhile, real outlays for services rose at an annual rate of about 3 percent in the first quarter, and the available data point to an increase of about the same magnitude in the second quarter.

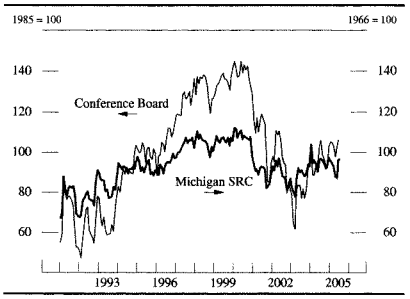
If the effect of Microsoft's $32 billion special dividend payment in December 2004 is excluded from the calculation, real disposable personal income (that is, after-tax income adjusted for inflation) rose at an annual rate of about 2 percent between the fourth quarter of 2004 and May 2005, a slower pace than in 2004. Although increases in employment and earnings pushed up wage and salary income over the first half of 2005, the rise in real income was damped to some degree by the energy-driven increase in consumer prices. Higher energy prices also appear to have weighed on consumer confidence for much of this year. Surveys by both the Michigan Survey

Change in real income and consumption



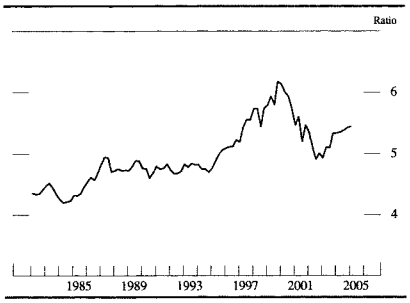
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Consumer sentiment



NOTE: The Conference Board data are monthly and extend through June 2005. The Michigan SRC data are monthly and extend through a preliminary estimate for July 2005.
SOURCE: The Conference Board and University of Michigan Survey Research Center.

Wealth-to-income ratio



NOTE: The data are quarterly and extend through 2005:Q1. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.
SOURCE: For net worth, Federal Reserve Board, flow of funds data; for income, Department of Commerce, Bureau of Economic Analysis.

Research Center (SRC) and the Conference Board indicate that household sentiment edged down through the early spring, though readings from these surveys turned up again more recently.

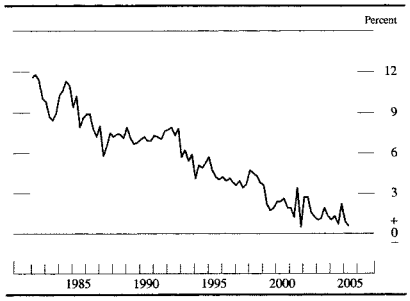
Household wealth appears to have increased a bit faster than nominal disposable income over the first half of this year; the small increase in the wealth-to-income ratio comes on the heels of substantial increases in 2003 and 2004. Although stock prices have changed little, on net, thus far this year, home prices have continued to rise sharply. Because changes in wealth influence consumer spending with a lag, both the earlier and the more-recent increases in household net worth have supported consumption this year. As wealth increased and interest rates remained quite low, the personal saving rate edged down to just ½ percent of disposable income in April and May. Over the previous two decades, the personal saving rate averaged close to 5 percent.

Residential Investment

Activity in the housing market continued at a strong pace in the first half of 2005. Real expenditures on residential structures increased at an annual rate of 11½ percent in the first quarter and appear to have posted another gain in the second quarter. In the single-family sector, starts of new units averaged 1.69 million at an annual rate between January and June—nearly 4 percent above the pace posted over the second half of 2004. Similarly, starts of multifamily units averaged 360,000 over the first six months of 2005, about 3¼ percent higher than in the previous six months.

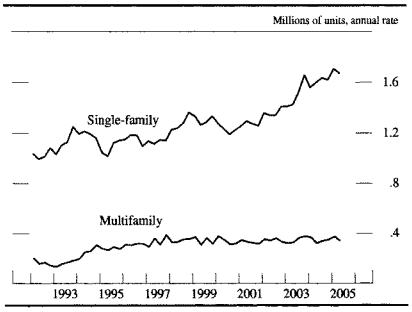
As in 2004, the demand for housing during the first half of 2005 was supported by rising employment and income and by low mortgage rates. Rates on thirty-year fixed-rate mortgages have fluctuated between 5½ percent and 6 percent in recent months and are currently near the low end of that range. In addition, demand reportedly has been boosted by a rise in purchases of second homes—either as vacation units or as investments—and by the greater availability of less-conventional financing instruments. These financing instruments, including interest-only mortgages and adjustable-rate mortgages that allow borrowers a degree of flexibility in the size of their monthly payments, have enabled some households to buy homes that would otherwise have been unaffordable. As a result, both new and existing home sales have remained remarkably robust this year, and both were at or near record levels in May.

Personal saving rate



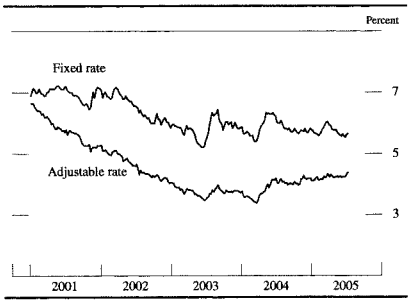
NOTE: The data are quarterly; the reading for 2005:Q2 is the average of April and May.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Private housing starts



NOTE: The data are quarterly and extend through 2005:Q2.
SOURCE: Department of Commerce, Bureau of the Census.

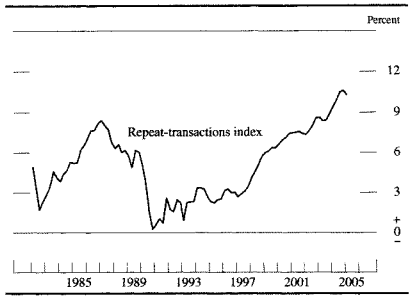
Mortgage rates



NOTE: The data, which are weekly and extend through July 13, 2005, are contract rates on thirty-year mortgages.
SOURCE: Federal Home Loan Mortgage Corporation.

The strong demand for housing has continued to push up home prices this year. Although rates of house price appreciation were a little slower in the first quarter of this year than in 2004, the repeat-transactions price index for existing homes (limited to purchase-transactions only), which is published by the Office of Federal Housing Enterprise Oversight and partially adjusts for changes in the quality of homes sold, was nonetheless up 10 percent relative to its year-earlier level. Price appreciation has been especially sharp over the past year in some large metropolitan areas, including Las Vegas, Miami, San Francisco, and New York, but rapid increases in home prices have been observed in other areas as well. In many of these locales, recent price increases have far exceeded the increases in rents and household incomes.

Change in house prices



NOTE: The data are quarterly and extend through 2005:Q1. Change is over four quarters. For the years preceding 1991, changes are based on an index that includes appraisals associated with mortgage refinancings. Beginning in 1991, changes are based on an index that includes purchase transactions only.
SOURCE: Office of Federal Housing Enterprise Oversight.

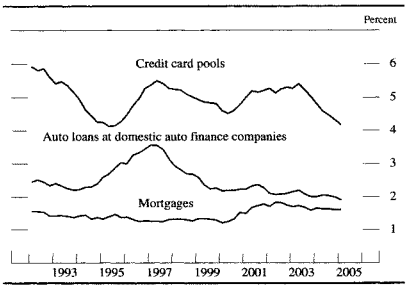
Household Finance

Supported by rising house prices and continued economic expansion, household debt increased at an annual rate of about 9¼ percent in the first quarter of 2005. This advance was paced by a rise in mortgage debt of 10½ percent at an annual rate. However, even that rapid rise in mortgage debt represented a slight deceleration from the torrid pace in 2004, a development in line with the small slowdown in the pace of house price appreciation. Despite the increase in mortgage debt, net housing wealth rose. Refinancing activity has remained subdued, as rates on fixed-rate mortgages are a little above levels at which many households would currently find refinancing to be attractive.

Consumer credit expanded at an annual rate of about 4½ percent over the first quarter of the year and was about unchanged in April and May. The growth of consumer credit has continued to be restrained by substitution toward home equity debt as a means to finance household expenditures.

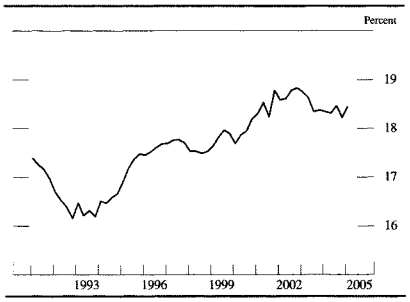
Measures of household credit quality have remained favorable. Delinquency rates on credit card debt and auto loans have continued to decline from already low levels. The pace of bankruptcy filings has run a little higher than at the same time last year; however, that pace has probably been boosted by a rush to file before the new rules in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 take effect in October. Reflecting the rapid pace of household debt growth, the ratio of household financial obligations to disposable personal income has edged up from a year earlier, though this ratio remains a bit below the peak level reached in late 2002.

Delinquency rates on selected types of household loans



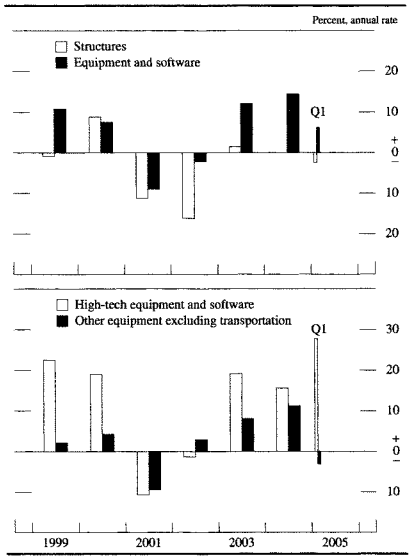
NOTE: The data are quarterly and extend through 2005:Q1.
SOURCE: For credit cards, Moody's Investors Service; for auto loans, the financing subsidiaries of the three major U.S. automobile manufacturers; for mortgages, Mortgage Bankers Association.

Household financial obligations ratio



NOTE: The data are quarterly and extend through 2005:Q1. The financial obligations ratio equals the sum of required payments on mortgage and consumer debt, automobile leases, rent on tenant-occupied property, homeowners' insurance, and property taxes, all divided by disposable personal income.
SOURCE: Federal Reserve Board.

Change in real business fixed investment



NOTE: High-tech equipment consists of computers and peripheral equipment and communications equipment.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

The Business Sector

Fixed Investment

After posting a robust gain in the second half of 2004, real business fixed investment rose at a more moderate pace over the first half of 2005, as the rate of increase in expenditures on equipment and software (E&S) dropped back and outlays for nonresidential structures remained lackluster. Nonetheless, economic and financial conditions appear to be supportive of capital spending: Sales and corporate profits have continued to increase, businesses have ample liquid assets at their disposal, and financial market participants appear willing to finance new investment projects at favorable terms.

Real E&S spending rose at an annual rate of 6 percent in the first quarter after having advanced at an 18 percent pace in the second half of 2004. Led by large increases in purchases of computers and communications equipment, spending on high-tech equipment posted a sizable gain in the first quarter. In contrast, outlays for transportation equipment dropped back early in the year because of a small decline in business expenditures on motor vehicles and a sharp drop in aircraft purchases after a surge in the fourth quarter of 2004. Investment in equipment other than high-tech and transportation goods, a category that accounts for about 40 percent of E&S in nominal terms, also edged down in the first quarter after registering a sizable gain in the second half of last year. The types of equipment in this category of investment tend to be sensitive to trends in business sales, but the timing of business spending may have been influenced by the provisions of the partial-expensing tax incentive, which encouraged capital spending to be pulled forward in advance of the incentive's expiration at the end of 2004.

More-recent indicators of E&S spending point to another moderate rise in investment in the second quarter. In particular, outlays for transportation equipment appear to have turned up, on net, as a step-up in purchases of aircraft more than offset a further decline in business spending on motor vehicles. At the same time, the evidence on high-tech spending has been mixed: Real spending on computers appears to have registered another large gain in the second quarter, while the rate of increase in outlays for communications equipment apparently fell back. Indicators of spending on equipment other than transportation and high tech have looked more favorable recently, as shipments and imports for this broad category increased noticeably, on balance, in April and May. In addition, unfilled orders for such equipment remain at high levels.

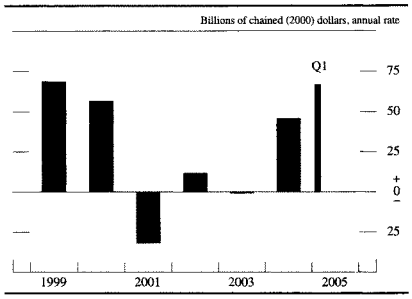
Real nonresidential construction continued at a low level in the first half of this year, but fundamentals are starting to show signs of improvement. The construction of office buildings and industrial facilities has been restrained for some time by elevated vacancy rates, weak

demand, and higher costs for construction materials. However, vacancy rates in these sectors have recently turned down, and construction outlays for these types of buildings appear to have edged higher, on net, so far this year. Commercial building—which includes retail outlets and warehouses—also appears to have increased this year, in part because of strong growth in the construction of large retail stores. Meanwhile, investment in the drilling and mining sector has trended up, on balance, over the past year, as higher prices for natural gas boosted the demand for new drilling rigs.

Inventory Investment

As in 2004, businesses accumulated inventories at an appreciable pace early this year. Outside the motor vehicle industry, nonfarm inventories increased at an annual rate of $66 billion in real terms in the first quarter of 2005. The rapid rate of inventory accumulation late last year and early in 2005 appears primarily to have been the result of efforts by firms to replenish stocks that had been depleted by the strong pace of sales in 2003 and 2004; apart from firms in a limited number of sectors, such as steel and paper, most businesses do not appear to be holding excess stocks, even taking into account the downward trend in inventory–sales ratios that has resulted from the improvement in supply-chain management capabilities. The rebuilding of inventories in most industries appears to have been largely completed, and the available data for April and May point to a noticeable step-down in the pace of stockbuilding. Indeed, in recent surveys, businesses have been reporting that they and their customers are increasingly comfortable with current levels of stocks, whereas in 2004 and early 2005, many were still characterizing inventory positions as too lean.

Change in real business inventories



SOURCE: Department of Commerce, Bureau of Economic Analysis.

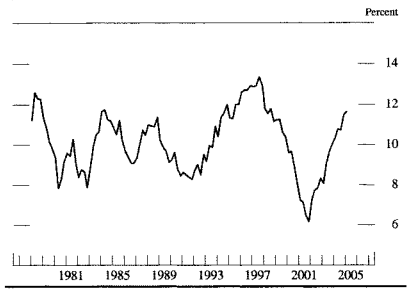
One important exception to this characterization is the motor vehicle industry, for which dealer stocks—especially of light trucks—were high by historical standards in recent months. In response, several major motor vehicle manufacturers reduced production in the second quarter, and, more recently, some have introduced price discounts on many 2005 models. These efforts appear to have helped, in that inventories of light vehicles at the end of June fell to sixty-five days of supply, a level more in line with historical norms.

Corporate Profits and Business Finance

Corporate profits have continued to rise so far this year, though at a slower pace than in 2003 and 2004. Earnings per share for S&P 500 firms in the first quarter of 2005 were up about 13 percent since the same time last year, a pace in line with the profit figures reported in the national income and product accounts (NIPA). The ratio of before-tax profits of nonfinancial corporations to that sector's gross value added was about flat in the first quarter after having moved up in 2003 and 2004. In the first half of this year, the petroleum and gas industries benefited from higher oil prices, but corporate earnings in the automobile sector declined sharply.

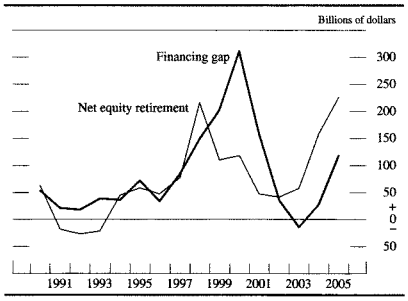
Given continued strong corporate profits and the accompanying strength in cash flow, nonfinancial firms' demand for external financing to fund capital expenditures has remained somewhat subdued. Net equity issuance has stayed negative so far this year, and share retirements have been boosted by considerable stock buybacks and cash-financed merger and acquisition activity. Gross corporate bond issuance has been limited, and the pro-

Before-tax profits of nonfinancial corporations as a percent of sector GDP



NOTE: The data are quarterly and extend through 2005:Q1. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Financing gap and net equity retirement at nonfinancial corporations

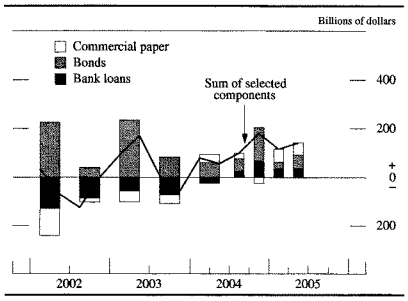


NOTE: The data are annual through 2004; for 2005, they are estimates based on data from 2005:Q1. The financing gap is the difference between capital expenditures and internally generated funds. Net equity retirement is the difference between equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms and equity issued in public or private markets, including funds invested by venture capital partnerships.
SOURCE: Federal Reserve Board, flow of funds data.

ceeds have been used mainly to pay down existing debt. Short-term debt financing, however, continued to pick up in the first half of 2005. Both commercial and industrial loans and commercial paper expanded at a brisk pace that was likely in part the result of firms' need to fund the rapid rate of inventory accumulation earlier in the year. The Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices conducted in April 2005 indicated that demand for business loans had strengthened over the previous three months and that substantial fractions of banks had eased standards and terms on these loans. In response to special questions regarding longer-term changes in lending practices, most banks reported that standards on business loans were somewhat tighter, but that terms were somewhat easier, than they had been in 1996 and 1997.

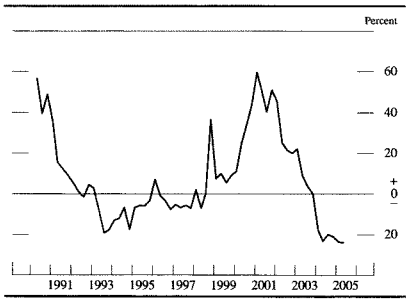
Indicators of credit quality in the nonfinancial business sector have stayed generally very strong amid continued growth of profits and corporate balance sheets that remain flush with liquid assets. Both the default rate on outstanding corporate bonds and the delinquency rate

Selected components of net business financing



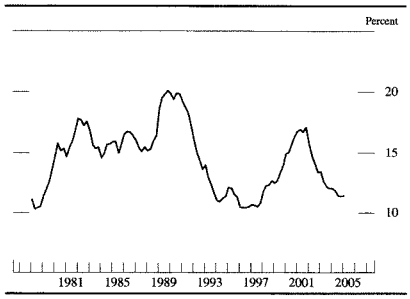
NOTE: Seasonally adjusted annual rate for nonfinancial corporate business. The data for the sum of selected components are quarterly. The data for 2005:Q2 are estimated.
SOURCE: Federal Reserve Board; Securities Data Company; and Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

Net percentage of domestic banks tightening standards on commercial and industrial loans to large and medium-sized borrowers



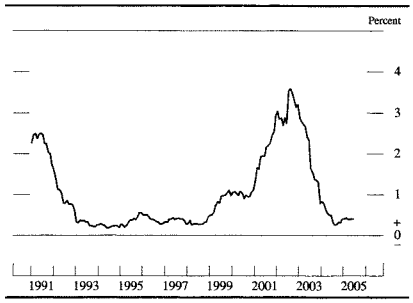
NOTE: The data are drawn from a survey generally conducted four times per year; the last observation is for the April (Q2) 2005 survey. Net percentage is the percentage of banks reporting a tightening of standards less the percentage reporting an easing. The definition for firm size suggested for, and generally used by, survey respondents is that large and medium-sized firms have sales of $50 million or more.
SOURCE: Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices.

Net interest payments of nonfinancial corporations as a percent of cash flow



NOTE: The data are quarterly and extend through 2005:Q1.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Default rate on outstanding corporate bonds



NOTE: The data are monthly and extend through June 2005. The rate for a given month is the face value of bonds that defaulted in the twelve months ending in that month divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the twelve-month period.
SOURCE: Moody's Investors Service.

on business loans stand at the low end of their historical ranges. However, the automobile sector has been an exception to the pattern of solid corporate credit quality. All three major credit rating agencies downgraded the debt of both Ford and General Motors this year in response to disappointing earnings news. General Motors' debt now has a below-investment-grade rating from both Standard & Poor's and Fitch, though it is still rated as investment-grade by Moody's. Ford retains an investment-grade rating with all the rating agencies except Standard & Poor's.

Expansion of commercial-mortgage debt continued apace in the first half of the year and was accompanied by record issuance of commercial-mortgage-backed securities. Likely because of that heavy issuance, spreads of yields on commercial-mortgage-backed securities over those on comparable-maturity Treasuries have turned up recently, but these spreads remain relatively low. The credit quality of commercial-mortgage debt remains quite strong, as delinquency rates on holdings of commercial mortgages at banks and insurance companies and on loans that back mortgage securities have been declining from already low levels.

The Government Sector

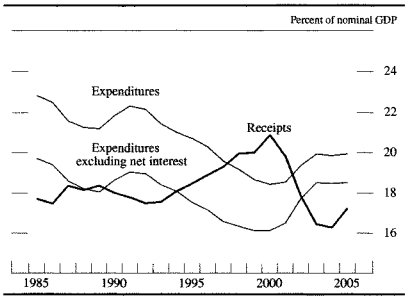
Federal Government

The deficit in the federal unified budget narrowed over the past year. Over the twelve months ending in June, the unified budget recorded a deficit of $336 billion, $99 billion less than during the comparable period last year. Both revenues and outlays rose faster than did nominal GDP over this period, but the rise in receipts was especially strong. Even at its lower level, the deficit was still equal to about 2¾ percent of nominal GDP.

Nominal federal receipts during the twelve months ending in June were 14 percent higher than during the same period a year earlier and reached 17 percent of nominal GDP. Revenues were boosted by a large increase in corporate receipts that was driven by the strength of corporate profits. In addition, individual income and payroll taxes rose nearly 12 percent, twice as fast as the growth of household income. However, some of this rise was due to the features of the Jobs and Growth Tax Relief Reconciliation Act of 2003 that altered the timing of tax payments in a way that temporarily reduced the level of tax collections last year.

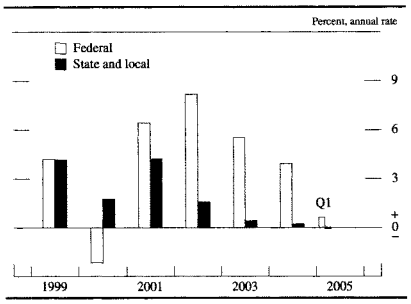
Nominal federal outlays during the twelve months ending in June were 7 percent higher than during the same period a year ago and stood at 20 percent of nominal GDP. Spending for national defense continued to trend up at a rapid clip, and outlays for Medicare also posted a sizable increase. In addition, federal net interest payments, boosted both by higher interest rates and by the higher level of federal debt, rose more than 13 percent over this period. Real federal expenditures for consumption and investment—the part of government spending that is a component of real GDP—increased at an annual rate of just ½ percent in the first calendar quarter of 2005 after having risen 4 percent in 2004. Although defense spending changed little in real terms in the first quarter, it has risen considerably in recent years and is likely to increase further in coming quarters. Nondefense spending in the first quarter edged up in line with its recent trend, and enacted legislation is consistent with its continuing to rise at a subdued pace.

Federal receipts and expenditures



NOTE: The budget data are from the unified budget through 2004 and are for fiscal years (October through September), and GDP is for Q4 to Q3. For 2005, the budget data are for the twelve months ending in June, and GDP is for 2004:Q4 to 2005:Q1.
SOURCE: Office of Management and Budget.

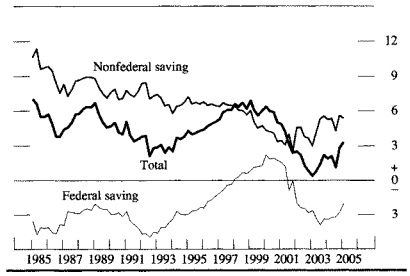
Change in real government expenditures on consumption and investment



SOURCE: Department of Commerce, Bureau of Economic Analysis.

The deficit in the federal budget has depressed national saving in the past few years. The narrowing of the deficit of late has lessened this reduction in national saving from a little more than 3 percent of nominal GDP in 2003 and 2004 to roughly 2 percent in the first quarter of 2005. Even so, as business and personal saving rates changed little, on average, over the past year, net national saving rose to just 3¼ percent of nominal GDP in the first quarter, well below the long-term historical average of about 7 percent and below recent levels of net domestic investment. If not reversed, such a low level of net national saving will necessitate either slower capital formation or continued heavy borrowing from abroad. The pressures on national saving will intensify greatly with the retirement of the baby-boom generation and the associated increases in Social Security and Medicare benefit payments.

Net saving



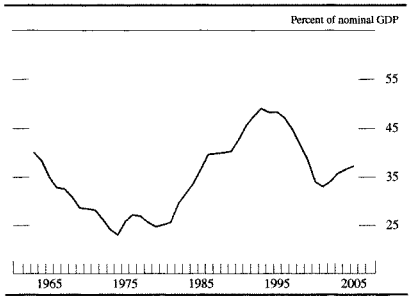
NOTE: The data are quarterly and extend through 2005:Q1. Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Federal Borrowing

Because of the need to finance the sizable federal budget deficit, federal debt held by the public expanded at a seasonally adjusted annual rate of 13¾ percent in the first quarter of the year. The ratio of this debt to nominal GDP increased to more than 37 percent for the first time since 2000. The average maturity of outstanding marketable Treasury debt has been declining for several years and reached fifty-three months at the end of the first quarter of 2005, down from about seventy months in 2000. However, in the May mid-quarter refunding statement, the Treasury announced that it was considering reintroducing regular issuance of a thirty-year nominal bond in February 2006, a move that would presumably slow or arrest this downtrend.

Indicators of demand for Treasury securities by foreign investors have been mixed so far this year; demand by foreign official institutions seems to have moderated, but demand by foreign private investors appears to have remained robust. Indirect bidders at Treasury auctions—which include foreign official institutions that place bids through the Federal Reserve Bank of New York—have been awarded an average of 33 percent of coupon securities issued at auctions held so far this year, down from 42 percent in 2004. Treasury securities held in custody at the Federal Reserve Bank of New York on behalf of foreign official institutions have grown only about $25 billion so far this year after an increase of more than $200 billion in 2004. Data from the Treasury International Capital System also suggest an ebbing of demand for Treasury securities from foreign official investors during the first five months of the year. These data, however, indi-

Federal government debt held by the public



NOTE: The final observation is for 2005:Q1. For previous years, the data for debt are as of year-end, and the corresponding values for GDP are for Q4 at an annual rate. Excludes securities held as investments of federal government accounts.
SOURCE: Federal Reserve Board, flow of funds data.

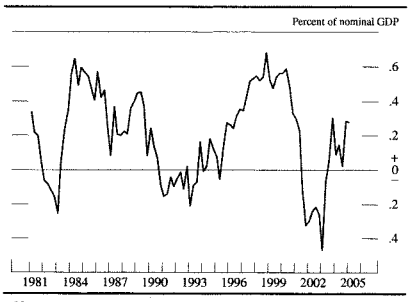
cate that foreign private investors have continued to accumulate Treasury securities at a rapid pace.

State and Local Governments

The fiscal positions of states and localities have improved this year. Ongoing gains in income and consumer spending, along with sharp increases in property values, have continued to boost tax receipts. Although many jurisdictions have increased their spending moderately, some are also using the additional revenues to rebuild reserve funds. On a NIPA basis, net saving by state and local governments equaled $34 billion at an annual rate in the first quarter (roughly ¼ percent of nominal GDP), double the 2004 average. In addition, virtually all states registered surpluses in their general fund budgets in fiscal year 2005, which ended on June 30 for all but four states. Nevertheless, lingering fiscal concerns are still evident in some jurisdictions; these concerns are related primarily to rising Medicaid costs, the termination of temporary federal grants that were appropriated in fiscal year 2004, and pressures to restore funding to programs—such as elementary and secondary education—that were cut back earlier in the decade.

Real consumption and investment spending by state and local governments edged down in the first quarter of 2005 after having changed little in 2004. Real outlays for consumption items increased at an annual rate of less than ½ percent, a reflection of some slowing in the pace of hiring. Nominal spending on investment rose at a moderate rate in the first quarter, but because construction costs escalated, investment spending declined a little in real terms.

State and local government net saving



NOTE: The data, which are quarterly, are on a national income and product account basis and extend through 2005:Q1. Net saving excludes social insurance funds.

SOURCE: Department of Commerce, Bureau of Economic Analysis.

State and Local Government Borrowing

State and local government debt held by the public expanded at a rapid pace in the first quarter of the year, rising at a seasonally adjusted annual rate of 16¼ percent, up from 5½ percent in the fourth quarter of last year. However, much of this borrowing was for the advance refunding of existing debt, as state and local governments continued to take advantage of low long-term interest rates. A significant portion of the proceeds of these advance refundings were invested in U.S. Treasury instruments tailored to meet the cash management needs of municipal governments. In addition, financing of transportation- and education-related projects boosted issuance of long-term municipal bonds for new capital.

The credit quality of municipal borrowers improved last year, and this trend has generally continued so far in 2005, as upgrades of municipal bonds by Standard & Poor's continued to outpace downgrades.

The External Sector

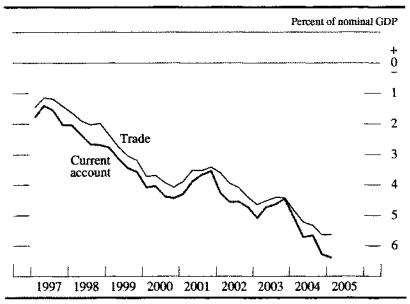
The U.S. current account deficit expanded in the first quarter of 2005 to $780 billion at an annual rate, or about 6.4 percent of nominal GDP. The deficit in trade in goods continued to widen, increasing $17 billion from the previous quarter. The deficit on net unilateral transfers also widened in the first quarter, largely because of an increase in government grants. In contrast, the surplus on trade in services rose $7 billion, and the surplus on net investment income rose $2 billion.

International Trade

Real exports of goods and services accelerated in the first quarter of 2005 to an annual rate of about 9 percent, roughly twice as fast as the rate in the second half of last year. The dollar's decline in recent years has raised the competitiveness of U.S. relative prices and has continued to provide a mounting boost to exports. Support from foreign economic activity, though still substantial, moderated after the first half of 2004 as growth abroad slowed. Increases in exports of U.S. goods were widespread across major U.S. trading partners, with the exception of Japan, and were concentrated in capital goods and consumer goods. Real exports of services rose at an annual rate of about 13¼ percent.

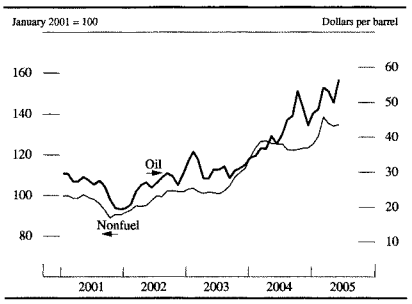
Real imports of goods and services rose at an annual rate of about 9½ percent in the first quarter, a pace similar to the average in 2004. The growth of real oil imports ebbed after surging late last year. Increases in imports of non-oil goods were widespread across categories. The

U.S. trade and current account balances



NOTE: The data are quarterly and extend through 2005:Q1.
SOURCE: Department of Commerce.

Prices of oil and of nonfuel commodities

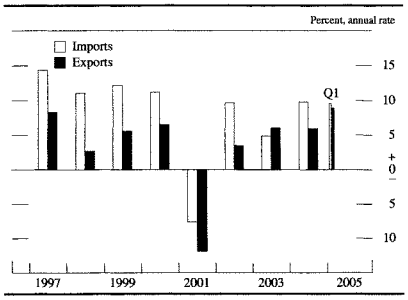


NOTE: The data are monthly and extend through June 2005. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is an index of forty-five primary-commodity prices.
SOURCE: For oil, *Wall Street Journal;* for nonfuel commodities, International Monetary Fund.

expiration of the Multifibre Arrangement and the resulting elimination of quotas shifted the source of some U.S. textile and apparel imports among U.S. trading partners, but these events appear to have had a limited effect on the overall level of imports of these goods. Real imports of services reversed their fourth-quarter decline, posting a gain of 7 percent at an annual rate, as some travel-related expenditures and also royalties and license fees recovered from a very weak fourth quarter.

Boosted by substantial increases in the prices of primary commodities and industrial supplies, prices of total exports rose at an annual rate of 4¼ percent in the first quarter. Prices of U.S. agricultural exports rebounded in the first quarter after good harvests in the second half of 2004 had caused prices to fall sharply. The available data for the second quarter point to continued increases in export prices.

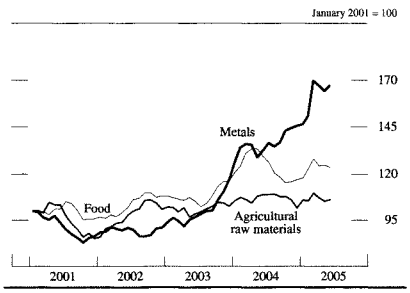
Change in real imports and exports of goods and services



SOURCE: Department of Commerce.

Prices of imported non-oil goods rose at an annual rate of 3¾ percent in the first quarter, almost 1½ percentage points faster than in the second half of 2004. Prices of material-intensive items, such as industrial supplies and foods, steadily increased in the last quarter of 2004 and in the first quarter of 2005. In part, this rise reflected higher prices for nonfuel primary commodities, as strength in global demand for many commodities outstripped a slow expansion of supply. Prices for finished goods, such as consumer goods and many kinds of capital goods, also turned noticeably higher. Available data for the second quarter show that the increases in prices of both material-intensive and finished goods have slowed.

Prices of major nonfuel commodities



NOTE: The data are monthly and extend through June 2005. The category of agricultural raw materials consists of timber, cotton, wool, rubber, and hides; food includes cereals, vegetable oils and protein meals, seafood, and meat; and metals includes aluminum, copper, and iron ore.
SOURCE: International Monetary Fund.

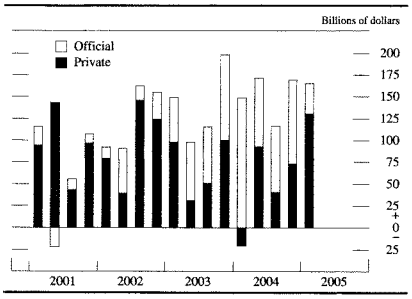
The spot price of West Texas intermediate (WTI) crude oil began 2005 near $43 per barrel, but it climbed above $50 per barrel in late February and breached $60 per barrel in late June. The increase in the spot price of WTI largely reflects several global factors: continued strong demand for oil, limited spare production capacity, and concerns about the reliability of supply from some foreign sources. In contrast to the market outlook during last October's peak in oil prices, futures contracts indicate that market participants now expect oil prices to remain near their current high levels, a view consistent with the belief that demand will remain strong and production will have difficulty keeping pace. The price of the far-dated NYMEX oil futures contract (currently for delivery in December 2011) rose from about $38 per barrel as of last October to about $56 per barrel in late June.

OPEC spare production capacity appears to be near historical lows, with only Saudi Arabia able to increase production substantially. Many other OPEC producers are either pumping close to capacity or encountering production problems. Venezuela and Indonesia cannot meet their production quotas, and Iraqi production this year has averaged less than in 2004. In addition, several governments have moved to increase their control of the energy industry as oil prices have risen. Russian oil production, which had provided most of the growth in non-OPEC supply over the previous five years, has stagnated since last September amid the partial nationalization of Yukos, formerly Russia's largest oil company. Venezuela has also increased the taxes and royalty payments of foreign oil firms.

The Financial Account

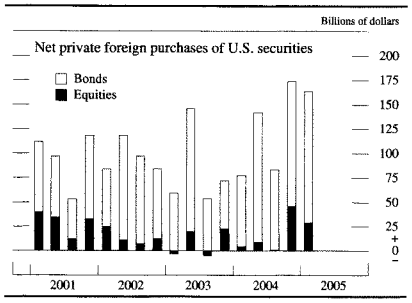
Foreign official inflows, which accounted for more than half of all net financial inflows to the United States in 2004, slowed significantly in the first quarter but showed signs of renewed strength in April and May. In contrast, private inflows moderated in April and May after having increased substantially in the preceding six months. As has been the case for several years, the U.S. current account has been financed primarily by foreign purchases of U.S. debt securities. U.S. residents' purchases of foreign securities increased after a temporary lull in the fourth quarter and have been more heavily weighted toward purchases of equities.

U.S. net financial inflows



SOURCE: Department of Commerce.

U.S. net international securities transactions



SOURCE: Department of Commerce and the Federal Reserve Bank of New York.

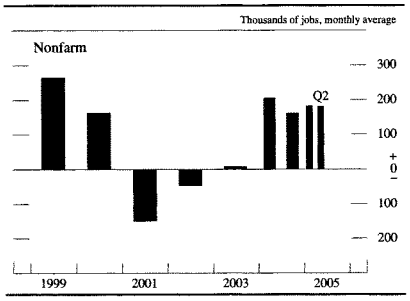
Net direct investment outflows in the first quarter were well below their levels in the fourth quarter; direct investment into the United States was roughly unchanged, but U.S. direct investment abroad fell back after a surge in new equity late last year. There is little evidence to date that U.S. companies have repatriated earnings from their foreign subsidiaries using the temporarily reduced tax rate available under the American Jobs Creation Act of 2004. However, there are indications that these remittances may pick up in the second half of this year.

The Labor Market

Employment and Unemployment

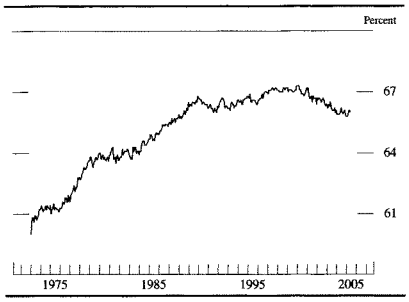
Labor markets have continued to improve this year, albeit at an uneven pace from month to month. On average, nonfarm payroll employment expanded roughly 180,000 per month over the first half of 2005, about the same pace as in the fourth quarter of 2004. At the same time, the civilian unemployment rate, which had declined from 5¾ percent to just below 5½ percent over 2004, continued to move down. The jobless rate stood at 5 percent in June, the lowest level since September 2001.

Net change in payroll employment



SOURCE: Department of Labor, Bureau of Labor Statistics.

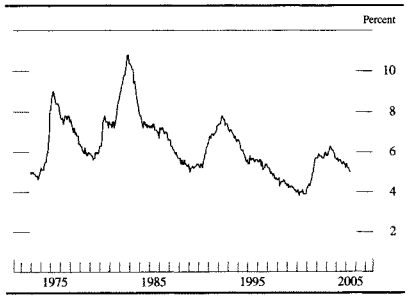
Labor force participation rate



NOTE: The data are monthly and extend through June 2005.
SOURCE: Department of Labor, Bureau of Labor Statistics.

The increases in payrolls over the first half of 2005 were relatively widespread across industries. Particularly sizable gains were registered at providers of health-care services and leisure and hospitality services and at establishments that provide business services, such as professional and technical assistance and administrative and support services (a category that includes temporary help). In addition, construction employment continued to climb at a steady pace, a reflection of the buoyant residential housing market and increased spending on infrastructure by state and local governments. In contrast, manufacturing employment continued to trend down, as cutbacks in industries that produce wood products, furniture, and a variety of nondurable goods more than offset hiring at producers of fabricated metals and machinery. Employment in retail trade has advanced at a moderate pace this year. Increases in employment at state and local governments slowed somewhat in the first half of this year from the pace in the second half of last year, and federal civilian employment changed little.

Civilian unemployment rate



NOTE: The data are monthly and extend through June 2005.
SOURCE: Department of Labor, Bureau of Labor Statistics.

The gradual rise in job opportunities appears to be attracting some potential workers back into the labor market. The labor force participation rate, which had declined noticeably between 2000 and 2004, edged up over the first half of 2005. Nevertheless, the participation rate in June, at 66 percent, remained well below the high of 67¼ percent reached in early 2000. To some extent, both the high level of the participation rate in 2000 and the more recent decline are likely related to cyclical developments in the economy: The tight labor markets of the late 1990s, perhaps coupled with the introduction of work requirements for many welfare recipients, undoubtedly drew additional people into the labor force at that time, while the subsequent recession and slow recovery in the labor market have discouraged many job seekers in recent years. However, the downtrend in the aggregate participation rate also appears to be associated with structural developments that seem likely to limit future increases. For example, the large baby-boom cohorts are now entering ages at which labor force participation rates typically drop off sharply. And, in contrast to patterns observed in previous decades, participation rates for women between 25 and 54 years of age no longer appear to be trending up.

Productivity and Labor Costs

Gains in labor productivity have slowed, on balance, in recent quarters. According to currently published data, output per hour in the nonfarm business sector rose 2½ percent over the year ending in the first quarter of

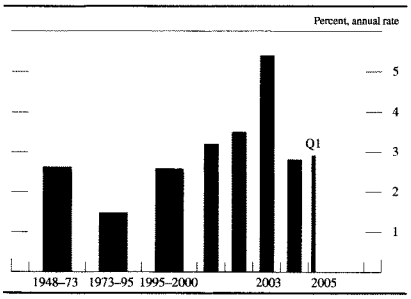
2005, down from the 5½ percent pace registered in the comparable period a year earlier. A deceleration in productivity is not unusual as an economic expansion matures and as businesses—which become increasingly confident about future prospects for sales—step up their pace of hiring. In addition, the recent slowdown in productivity growth was from the unusually rapid average rate that prevailed between 2002 and early 2004. That elevated rate likely reflected both an atypical reluctance to hire—as employers reacted to a succession of economic and geopolitical shocks—and newfound efficiencies brought about by the better use of high-tech capital purchased by businesses in earlier years and by organizational changes implemented to maintain profitability when the economy was relatively weak. As the impetus from these influences has waned, productivity growth has fallen back.

Measures of labor compensation for recent quarters suggest that the remaining slack in labor markets continued to restrain increases in base wage rates but that large increases in some of the more flexible components of worker pay and for some types of employer-provided benefits added to labor costs. In particular, compensation per hour in the nonfarm business sector, which is based on the data from the national income and product accounts, rose 7 percent over the four quarters ending in the first quarter of this year, having registered a particularly large bulge in the final quarter of 2004. Much of this sharp rise may be the result of the exercise of a large number of stock options late last year, a development perhaps induced by an increase in equity prices that boosted the number of options that were "in the money" and by a proposed change in accounting regulations that led some companies to accelerate the vesting of options that had been previously granted. In addition, the strong performance of profits in 2004 may have been associated with sizable nonproduction bonus payments at the end of last year.

A more modest rate of increase in hourly compensation is indicated by the employment cost index (ECI), which is based on a quarterly survey of private nonfarm establishments conducted by the Bureau of Labor Statistics and which excludes income received from the exercise of stock options. In particular, the ECI measure of hourly compensation rose 3½ percent over the twelve months ending in March 2005, about ½ percentage point less than the increases over the preceding two years. The wages and salaries component of the ECI was up just 2½ percent over the twelve months ending in March, a pace similar to that in the preceding year, while employer costs for benefits increased 5¾ percent, a bit below the pace of the previous year but a sizable gain nonetheless. Part of the outsized rise in benefit costs stemmed from the need by many companies to rebuild their defined-benefit pension assets to make up for earlier losses in those plans. In addition, health insurance costs have continued to rise more rapidly than wages, although the 7½ percent increase in these costs over the year ending in March of this year was down from the double-digit rates of growth in 2002 and 2003.

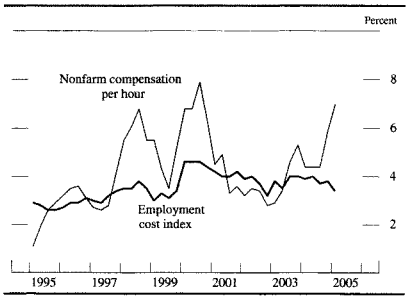
The acceleration in the nonfarm business measure of hourly compensation, coupled with the deceleration in productivity, has contributed to a noticeable pickup in unit labor costs in recent quarters. In particular, unit labor costs rose 4¼ percent over the four quarters ending in the first quarter of 2005 after having declined 1 percent over the preceding four quarters. However, to the extent that the acceleration in compensation was the

Change in output per hour



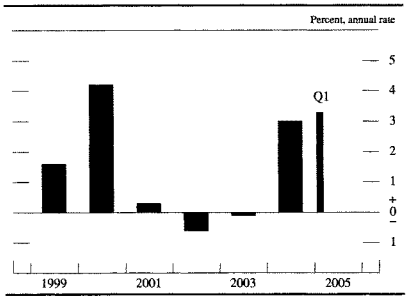
NOTE: Nonfarm business sector.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Measures of change in hourly compensation



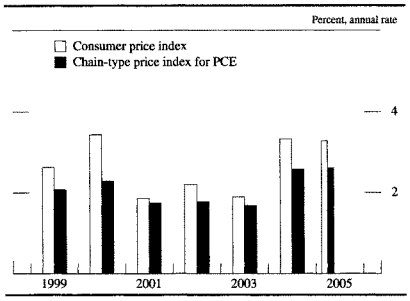
NOTE: The data are quarterly and extend through 2005:Q1. For nonfarm compensation, change is over four quarters; for the employment cost index (ECI), change is over the twelve months ending in the last month of each quarter. Nonfarm compensation is for the nonfarm business sector; the ECI is for private industry excluding farm and household workers.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Change in unit labor costs



NOTE: Nonfarm business sector. The change in unit labor costs is defined as the increase in nonfarm compensation per hour less the growth in labor productivity.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Change in consumer prices



NOTE: For 2005, the change for the PCE price index is from 2004:Q4 to May 2005; for the consumer price index, it is from 2004:Q4 to 2005:Q2.
SOURCE: For consumer price index, Department of Labor, Bureau of Labor Statistics; for chain-type measure, Department of Commerce, Bureau of Economic Analysis.

result of a temporary bulge in stock option exercises in late 2004, unit labor costs should moderate significantly this year. Moreover, the implications of such a spike in unit labor costs for price inflation are probably minimal, at least as judged by previous spikes of this nature. For example, the sharp rise in unit labor costs in 2000 had little or no subsequent effect on price inflation.

Prices

Higher energy prices continued to show through to overall consumer price inflation this year. The chain-type price index for personal consumption expenditures rose at an annual rate of about 2½ percent between the fourth quarter of 2004 and May 2005, a rate of increase similar to that over the four quarters of 2004. Within that total, core PCE prices accelerated over that period to an annual rate of about 2 percent, from 1½ percent in 2004. However, data for the consumer price index (CPI), which are available through June, suggest that core inflation has moderated in recent months; the core CPI rose at an annual rate of 1¼ percent in the three months ending in June after having increased at a 3¼ percent pace over the first three months of this year.

The PCE price index for energy, which moved up more than 18 percent in 2004, increased at an annual rate of nearly 14 percent between the fourth quarter of 2004 and May 2005, having been pushed higher by a further run-up in crude oil prices. Gasoline prices climbed especially rapidly between February and April, when higher crude costs were accompanied by a significant widening in retail margins. Although these margins subsequently dropped back, retail gasoline prices in June were still nearly 10 percent above their level at the end of last year, and they moved up further in early July. Electricity prices also rose sharply over the first half of 2005 because of higher input costs for electricity generation.

Consumer food prices increased at an annual rate of about 2½ percent over the first half of 2005, a bit less than in 2004. Prices for fruits and vegetables dropped back early in the year, as supplies recovered from the damage associated with last year's succession of hurricanes. Although these prices turned up a little in the spring, they remain below their fourth-quarter levels. In contrast, meat prices rose at an annual rate of 3 percent over the first half of the year; relatively strong domestic demand has lifted prices despite increases in the number of cattle being fed for slaughter and ample supplies of other meats and poultry. Prices for beef were also influenced by a variety of trade restrictions associated with concerns about mad cow disease: Both the full resumption of imports

Alternative measures of price change

Percent

Price measure	2003 to 2004	2004 to 2005
Chain-type (Q1 to Q1)		
Gross domestic product (GDP)	1.7	2.4
Gross domestic purchases	1.7	2.8
Personal consumption expenditures (PCE)	1.7	2.2
Excluding food and energy	1.4	1.6
Market-based PCE excluding food and energy	1.3	1.7
Fixed-weight (Q2 to Q2)		
Consumer price index	2.9	2.9
Excluding food and energy	1.8	2.2

NOTE: Changes are based on quarterly averages of seasonally adjusted data.
SOURCE: For chain-type measures, Department of Commerce, Bureau of Economic Analysis; for fixed-weight measures, Department of Labor, Bureau of Labor Statistics.

from Canada (which would tend to push down prices) and the resumption of exports to other important trading partners (which would tend to push up prices) were delayed. Prices of food away from home, for which labor costs are more important than raw food costs, rose at an annual rate of about 3½ percent over the first half of this year, a little higher than the recent trend.

The pickup in core PCE inflation this year is due both to the sharp run-up in energy prices and to higher prices for other intermediate materials; these developments have raised production and distribution costs for a wide range of domestically produced goods and services. In addition, the decline in the exchange value of the dollar into early 2005 continued to push up prices of core nonfuel imports this year, both for items used in the domestic production of other goods and services and for items sold directly to consumers. Partially offsetting these influences have been the gains in productivity, which have enabled firms to absorb a portion of the higher costs. Moreover, although the price of crude oil remains high, prices for some other industrial materials have decelerated or edged down of late: The *Journal of Commerce* industrial price index—which excludes energy items—has fallen 6 percent since the beginning of April, while the producer price index for core intermediate materials rose at an annual rate of just 1¼ percent in the second quarter of this year after having increased at roughly a 7 percent pace, on average, in the preceding few quarters.

Measures of shorter-term inflation expectations have edged higher this year, while those of longer-term expectations have held steady or moved lower. Most notably, the Michigan SRC survey indicates that households' median expectations for inflation over the next twelve months have ranged between 3 percent and 3¼ percent in recent months, up from just under 3 percent at the beginning of the year. In contrast, households' median expectations for inflation over the next five to ten years, at a little under 3 percent, are similar to readings in recent years. The latest Survey of Professional Forecasters likewise shows that inflation is expected to average 2½ percent over the next ten years, a figure unchanged since 2001. Readings of longer-term inflation compensation from financial markets show a more pronounced decline: Inflation compensation as measured by the spread of the yield on nominal Treasury securities over their indexed counterparts for the period five to ten years ahead has fallen about 50 basis points since the end of 2004.

U.S. Financial Markets

Financial market conditions remained generally accommodative during the first half of 2005, as Treasury and private interest rates stayed low. Risk spreads on speculative-grade debt had become very tight by the end of the first quarter, but they subsequently rose, on balance, after the downgrades of Ford and General Motors; current levels suggest more-typical compensation for default risk. Banks continued easing terms and standards on lending to businesses. The pace of business borrowing, which had been sluggish, picked up last year and remained fairly robust in the first half of 2005. Nevertheless, strong corporate profits and the large stockpile of liquid assets already on firms' balance sheets continued to limit their demand for external financing. Debt of the federal government, of state and local governments, and of households continued to expand briskly. Broad equity price indexes were little changed on net; higher oil prices boosted share prices in the energy sector but weighed on other stocks.

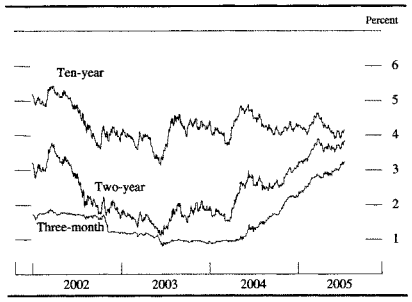
Interest Rates

The FOMC boosted the intended federal funds rate 25 basis points at each of its four meetings in the first half of the year. Judging from federal funds futures quotes, these policy actions had all been widely anticipated by investors for some time before each meeting. Since the start of the year, rates on interest rate futures contracts that will expire at the end of 2005 have moved up about 60 basis points in response to evidence of robust economic growth and concerns about the possible emergence of inflationary pressures. Two-year nominal Treasury yields have risen about 80 basis points over that period, reflecting both the firming of policy expectations and actual monetary policy tightening.

Nevertheless, ten-year nominal Treasury yields have edged down so far this year and are now about 60 basis points below their level just before the FOMC meeting in June 2004. Moreover, this fall in long-term yields is a global phenomenon: Long-term yields have declined in most foreign industrialized economies, in several cases by more than in the United States. From the term structure of interest rates, the ten-year Treasury yield can be decomposed into a series of ten consecutive one-year forward rates. The last of these—the one-year forward rate ending ten years hence—now stands about 160 basis points below its level just before the June 2004 FOMC meeting.

Several potential explanations have been offered for the decline in long-term yields and distant-horizon forward rates in the United States since mid-2004. Among these is the possibility that long-term inflation expectations have fallen and become more firmly anchored. Indeed, longer-term inflation compensation, measured by the spread between the yields on ten-year Treasury inflation-protected securities and their nominal counterparts,

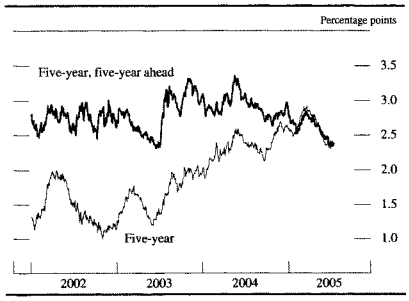
Interest rates on selected Treasury securities



NOTE: The data are daily and extend through July 13, 2005.
SOURCE: Department of the Treasury.

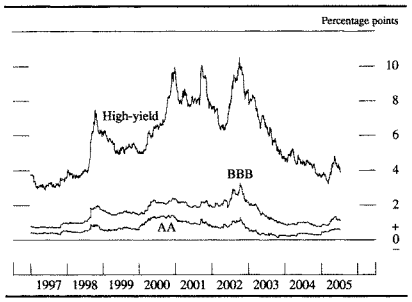
has fallen about 30 basis points over this period. A second possible explanation is investors' willingness to accept smaller risk premiums on long-term securities amid declining macroeconomic and interest rate uncertainty. The volatility of short-term interest rates and Treasury yields implied by option prices has indeed declined to historically low levels. A third possibility is that several factors have spurred an excess of global saving over planned investment, such as rising incomes in countries with high saving rates, the desire by the aging citizens of many industrialized countries to save for retirement, and apparently diminished investment prospects in many industrialized and developing economies.

TIPS-based inflation compensation



NOTE: The data are daily and extend through July 13, 2005. Based on a comparison of the yield curve for Treasury inflation-protected securities (TIPS) to the nominal off-the-run Treasury yield curve.
SOURCE: Federal Reserve Board calculations based on data provided by the Federal Reserve Bank of New York and Barclays.

Spreads of corporate bond yields over comparable off-the-run Treasury yields



NOTE: The data are daily and extend through July 13, 2005. The high-yield index is compared with the five-year Treasury yield, and the BBB and AA indexes are compared with the ten-year Treasury yield.
SOURCE: Merrill Lynch AA and BBB indexes and Merrill Lynch Master II high-yield index.

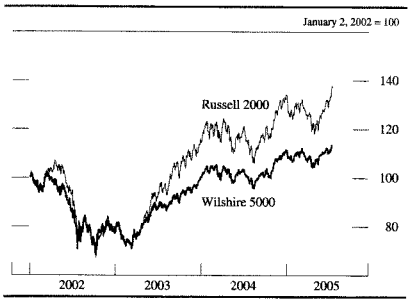
Spreads of yields on investment-grade corporate debt over those on comparable-maturity Treasury securities fell during the first quarter of 2005, and risk spreads on high-yield corporate debt reached very low levels. However, in March, news about difficulties in the domestic motor vehicle industry apparently became a focal point for a revision of investors' assessment of risks. Further revelations of accounting irregularities in the insurance industry also seem to have made investors somewhat charier of risk. As a result, risk spreads on corporate bonds and credit default swaps have widened; speculative-grade bond spreads are now about 50 basis points higher than at the start of the year.

Equity Markets

Broad equity price indexes fell modestly in the first quarter, but they rebounded and are now little changed, on net, since the start of 2005. Thus far this year, stock prices have been buoyed by continued strong profits and low long-term interest rates, but higher oil prices and a few high-profile earnings disappointments have weighed on share prices outside the energy sector. The forward earnings–price ratio held about steady despite the fall in real interest rates. Equity price volatility implied by quotes on stock options declined, as the implied volatility on the S&P 500 index dropped to a record low level of less than 11 percent.

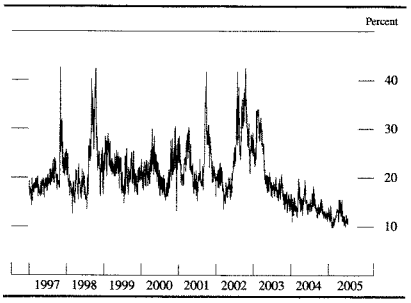
Net inflows into equity mutual funds were moderate in the first half of 2005, down from the rapid pace during the same period last year. These flows likely followed the pattern set by share prices, which surged about

Stock price indexes



NOTE: The data are daily and extend through July 13, 2005.
SOURCE: Frank Russell Company; Dow Jones Indexes.

Implied S&P 500 volatility



NOTE: The data are daily and extend through July 13, 2005. The series shown is the implied thirty-day volatility of the S&P 500 stock price index as calculated from a weighted average of options prices.
SOURCE: Chicago Board Options Exchange.

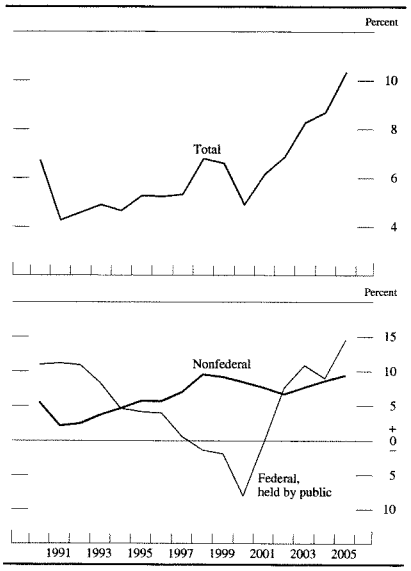
30 percent in 2003, rose about 10 percent in 2004, and have been flat so far this year.

Debt and Financial Intermediation

The aggregate debt of the domestic nonfinancial sectors expanded at an annual rate of about 10 percent in the first quarter of 2005, up from an 8¼ percent pace in the fourth quarter of 2004, mainly because of faster growth of federal government debt and state and local government debt. The mix of household and business debt growth has shifted modestly since the same time last year. Household debt decelerated, though it continued expanding at a rapid pace, and the growth of business-sector debt picked up even though ample internal funding continued to limit firms' need for external financing.

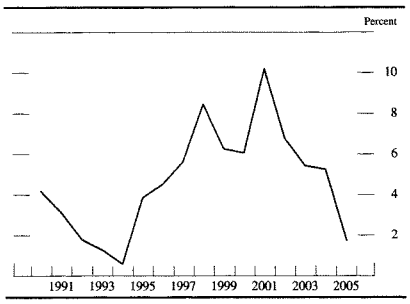
Commercial bank credit expanded at an annual rate of 13 percent in the first quarter of 2005. Financing secured by residential real estate, including home mortgages, home equity loans, and mortgage-backed securities, extended its long, robust expansion. In May, the Federal Reserve Board and other federal agencies that regulate depository institutions issued guidance on sound underwriting and effective credit-risk-management practices for home equity lending. Recently there has been increased use of potentially riskier types of mortgages, including adjustable-rate and interest-only loans, which could pose challenges to both lenders and borrowers. Business loans, which had begun to grow in 2004 after several years of runoffs, accelerated to a 15 percent annual rate of growth in the first quarter of 2005, supported in part by strong demand for short-term financing to fund rising accounts

Change in domestic nonfinancial debt



NOTE: For 2005, change is from 2004:Q4 to 2005:Q1 at an annual rate. For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year. The total consists of nonfederal debt and federal debt held by the public. Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, and nonfinancial businesses. Federal debt held by the public excludes securities held as investments of federal government accounts.
SOURCE: Federal Reserve Board, flow of funds data.

M2 growth rate



NOTE: For 2005, growth is estimated using monthly data through May; for earlier years, the data are annual averages. M2 consists of currency, traveler's checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds.
SOURCE: Federal Reserve Statistical Release H.6, "Money Stock Measures."

receivable, inventories, and merger and acquisition activity.

Credit market assets held by government-sponsored enterprises declined in the first quarter of this year, as Freddie Mac and Fannie Mae reduced their outright holdings of mortgage-backed securities.

The M2 Monetary Aggregate

In the first half of 2005, M2 grew at a 2½ percent annual rate—probably slower than nominal GDP and down from a 5¼ percent pace last year. Slower growth in liquid deposits—likely a consequence of their rising opportunity cost—accounted for most of this deceleration. Yields on retail money market mutual funds rose noticeably in the first half but continued to lag interest rates on market instruments, and assets in these funds continued their prolonged runoff. Small time deposits, whose yields have better kept pace with rising market interest rates, rose briskly during the same period. Currency expanded at a slow rate, apparently a reflection in large measure of weak demand from abroad. On net, the velocity of M2 is estimated to have moved up in the first half at a somewhat slower pace than would be expected from the historical relationship between money, income, and opportunity cost.

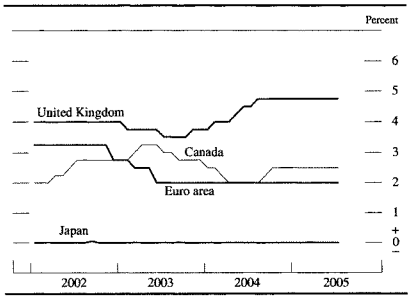
International Developments

Foreign economic activity has expanded a bit less rapidly this year than in the second half of 2004, as measured by an export-weighted average of growth among U.S. trading partners. The pace of expansion in the industrial economies has generally increased, but, with the important exception of China, this increase has been offset by moderating growth in many developing economies. Inflation has remained well contained in most countries.

The stance of monetary policy has not changed this year in most major foreign economies. The European Central Bank has held its policy rate constant since June 2003, and both the Bank of England and the Bank of Canada have kept policy rates unchanged after having raised them in the latter half of 2004. The Bank of Japan has maintained its commitment to a policy of quantitative easing until deflation ends, but in late May it made what it described as a technical change to allow temporary deviations below the target range for reserve accounts if banks' demand for funds is too weak to satisfy the target. Reserve account balances temporarily fell below ¥30 trillion, the lower end of the target, in early June. Monetary policy has also remained unchanged in most emerging Asian economies; however, several Latin American monetary authorities have continued tightening cycles that began last year in efforts to restrain inflationary pressures.

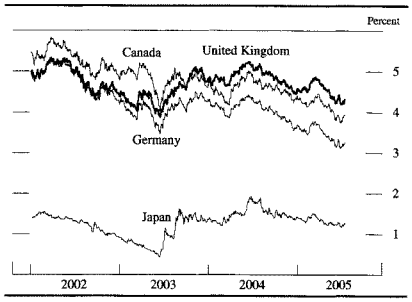
After having edged up during the first three months of this year, long-term interest rates in the major foreign industrial economies have fallen and now stand below their levels at the start of the year. As in the United States, the decline in foreign long-term interest rates continues a trend that began in mid-2004. However, long-term rates in the major foreign industrial economies have fallen more than rates in the United States this year. The decline in

Official interest rates in selected foreign industrial countries



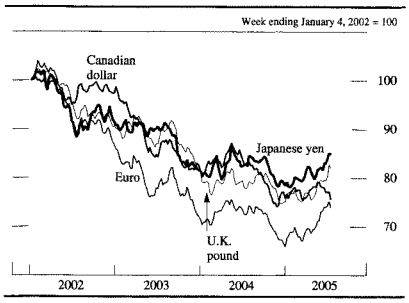
NOTE: The data are as of month-end; the last observation for each series is for July 13, 2005. The data shown are the call money rate for Japan, the overnight rate for Canada, the refinancing rate for the euro area, and the repurchase rate for the United Kingdom.

Yields on benchmark goverment bonds in selected foreign industrial countries



NOTE: The data are for ten-year bonds and are daily. The last observation is for July 13, 2005.
SOURCE: Bloomberg L.P.

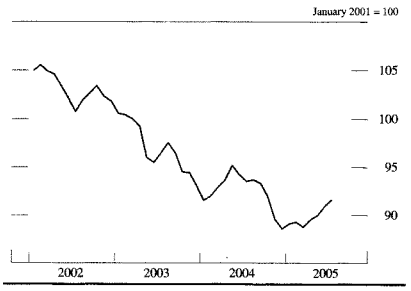
U.S. dollar exchange rate against selected major currencies



NOTE: The data are weekly and are in foreign currency units per dollar. The last observation for each series is the average of July 11, 2005, through July 13, 2005.
SOURCE: Bloomberg L.P.

European long-term rates occurred amid weak economic news and a shift away from market expectations of a policy rate increase. In contrast, long-term rates in Canada and the United Kingdom have trended down despite policy rate increases in the second half of last year by both countries' central banks, though market perceptions that the Bank of England may cut rates have recently increased. Although the decline in Japanese rates last year was consistent with both the weak performance of the economy and the persistence of deflation, long-term rates fell further this year despite solid growth in the first quarter.

U.S. dollar nominal exchange rate, broad index

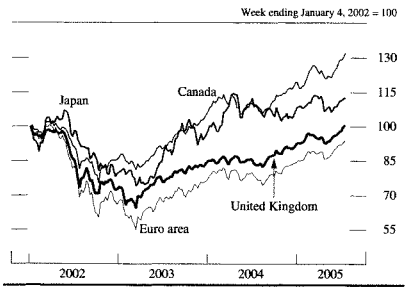


NOTE: The data are monthly and are in foreign currency units per dollar. The last observation is the average of trading days from July 1, 2005, through July 13, 2005. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.
SOURCE: Federal Reserve Board.

As foreign interest rates have fallen in recent months, the value of the dollar has risen. Most of this rise has been against the currencies of the major industrial countries; the dollar is largely unchanged against the currencies of the United States' other important trading partners. The dollar has appreciated about 12 percent against the euro and about 9 percent against the yen and sterling since the start of the year. Some of the appreciation against the euro occurred after voters in France and the Netherlands rejected the proposed constitution for the European Union by unexpectedly large margins in May.

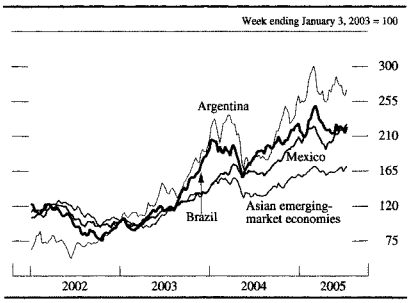
European, British, and Canadian stock indexes have risen more than 8 percent since the start of the year. The

Equity indexes in selected foreign industrial countries



NOTE: The data are weekly. The last observation for each series is the average of July 11, 2005, through July 13, 2005.
SOURCE: Bloomberg L.P.

Equity indexes in selected emerging-market economies



NOTE: The data are weekly. The last observation for each series is the average of July 11, 2005, through July 13, 2005. The Asian emerging-market economies are China, Hong Kong, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore, South Korea, Taiwan, and Thailand; the index weight for each of these economies is its market capitalization as a share of the group's total.

SOURCE: For Asian emerging-market economies, Morgan Stanley Capital International (MSCI) index; for others, Bloomberg L.P.

rise in European stock prices is notable because indicators of economic activity have been fairly weak. In contrast, Japanese stock prices are now little changed after having reversed first-quarter gains. Equity prices in the majority of emerging markets began the year on a strong note but reversed course late in the first quarter and currently stand close to their January levels. Despite these swings, intraday volatility has remained subdued in most equity markets.

Industrial Economies

Real GDP in Japan increased at an annual rate of nearly 5 percent in the first quarter of 2005, bouncing back from last year's recession. Personal consumption spending reversed its recent declines, pushing the household saving rate down further. Private investment also rose sharply after having grown tepidly in the second half of 2004. In contrast, the external sector made a small negative contribution to GDP, as imports rose modestly but exports fell. While Japanese manufacturers of high-tech goods reduced their levels of inventories from last year's peak, inventory stocks of firms outside the high-tech sector increased, perhaps because of the slowdown in exports. The labor market has steadily improved: The unemployment rate has reached a seven-year low, and the ratio of job offers to job applicants is at a twelve-year high. Despite the pickup in economic activity and continuing inflation in wholesale prices, consumer price deflation has worsened slightly. The GDP price deflator returned to a year-over-year rate of deflation of more than 1 percent after having temporarily registered a more modest decline in the fourth quarter of 2004.

The pace of activity in the euro area appears to have slowed after a stronger start to the year. Real GDP grew at a 2 percent annual rate in the first quarter, as private consumption rose moderately and both households and firms switched expenditures away from imports and toward domestically produced goods. Both Germany and Spain grew at rates above the area average in the first quarter. In contrast, real GDP in both Italy and the Netherlands declined, while French growth was slower than in most of 2004. Measures of activity point toward slower growth in the euro area in the second quarter. Retail sales, which had risen in the first quarter, were roughly flat, on average, in April and May. The trade balance fell in April, threatening a main engine of growth, though the recent rise in the dollar against the euro should help stimulate export demand going forward. Twelve-month consumer price inflation edged up in June to just above the European Central Bank's target ceiling of 2 percent for inflation over the medium term. The European Central Bank's measure of core inflation, which excludes energy and unprocessed foods, has eased since January to an annual rate comfortably below 2 percent.

Consumer spending in the United Kingdom increased only modestly in the first quarter, slowing real GDP growth to 1½ percent. Nevertheless, the labor market remains tight, as unemployment is at its lowest levels since the mid-1970s and real earnings continue to trend up. The twelve-month rate of consumer price inflation ticked up in June to the Bank of England's target of 2 percent. In its May *Inflation Report*, the Bank of England forecast that inflation would temporarily rise but stay near the target over a two-year period. House prices have been fairly stable this year, and household net mortgage borrowing has also been subdued.

Growth in Canada remains moderate. Continuing a pattern that has largely held for the past two years, private consumption and investment demand rose in the first quarter while net exports fell. Activity in the second quarter appears to have been solid. Data on housing starts indicate that construction spending grew further, and the merchandise trade surplus improved in April, as exports rose and imports decreased slightly. Twelve-month consumer price inflation fell in May to about 1½ percent after having averaged slightly above 2 percent in the first quarter. The Bank of Canada's measure of core inflation has stayed below 2 percent throughout this year.

Emerging-Market Economies

Chinese real GDP continues to rise rapidly following strong growth in 2004. Economic expansion has been led

by investment, exports, and, more recently, a surge in domestic production of goods that had previously been imported. Investment expenditure has remained vigorous despite the government's attempts early last year to slow its rate of increase. Import growth slowed in the first quarter, but the rise of exports was unabated, leading to a significant widening of the trade surplus. Although recent attention has focused on China's exports of textiles, export growth has remained strong across most major categories of goods. The slowdown in imports has also been broadly based. Despite China's strong rate of economic expansion, consumer price inflation fell to less than 3 percent in the first quarter and has remained low, as declining food prices have offset modest increases in nonfood prices.

Economic developments in other Asian emerging-market economies have varied. Hong Kong maintained its strong performance. As in China, growth in Hong Kong has been driven by both investment and exports. Export growth has also played an important role in supporting growth in most of the other countries in this region, but domestic demand, particularly inventory investment, has declined in many economies so far this year. Inflation has risen slightly, reflecting higher food and energy prices, but remains well contained and under 3 percent in most countries.

The Mexican economy has slowed so far this year, as demand for its manufacturing exports has weakened and monetary tightening has tempered investment and consumption demand. The Bank of Mexico has left monetary policy unchanged since March, but its tightening over the preceding twelve months raised short-term interest rates 500 basis points. Twelve-month consumer price inflation has fallen from its levels of late last year but still stands above the Bank of Mexico's target range of 2 percent to 4 percent. After having risen in the second half of last year, core inflation has also trended down in recent months.

Economic growth in most South American economies has also slowed compared with the pace of activity at the end of 2004. Brazil's real GDP rose at only a 1¼ percent annual rate in the first quarter, as both private consumption and investment declined in the wake of the Brazilian central bank's decision to begin raising its policy rate in the second half of 2004 to counter inflationary pressures. Exports, which rose rapidly and outpaced imports, provided the only bright spot. Twelve-month inflation has remained above 7 percent, and the central bank has continued to raise its policy rate this year. Argentina has gradually recovered from its 2001 crisis, but real GDP sharply decelerated in the first quarter. The unemployment rate, which had steadily fallen over the past few years, also edged up slightly. Twelve-month consumer price inflation appears to have stabilized after having been pushed up by food price increases earlier in the year, but it still lies above the central bank's unofficial target range of 5 percent to 8 percent. The Argentine government recently completed the final settlement of its debt exchange but has not yet resolved the treatment of the remaining investors (holders of roughly one-fourth of all defaulted government bonds) who rejected the agreement.

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